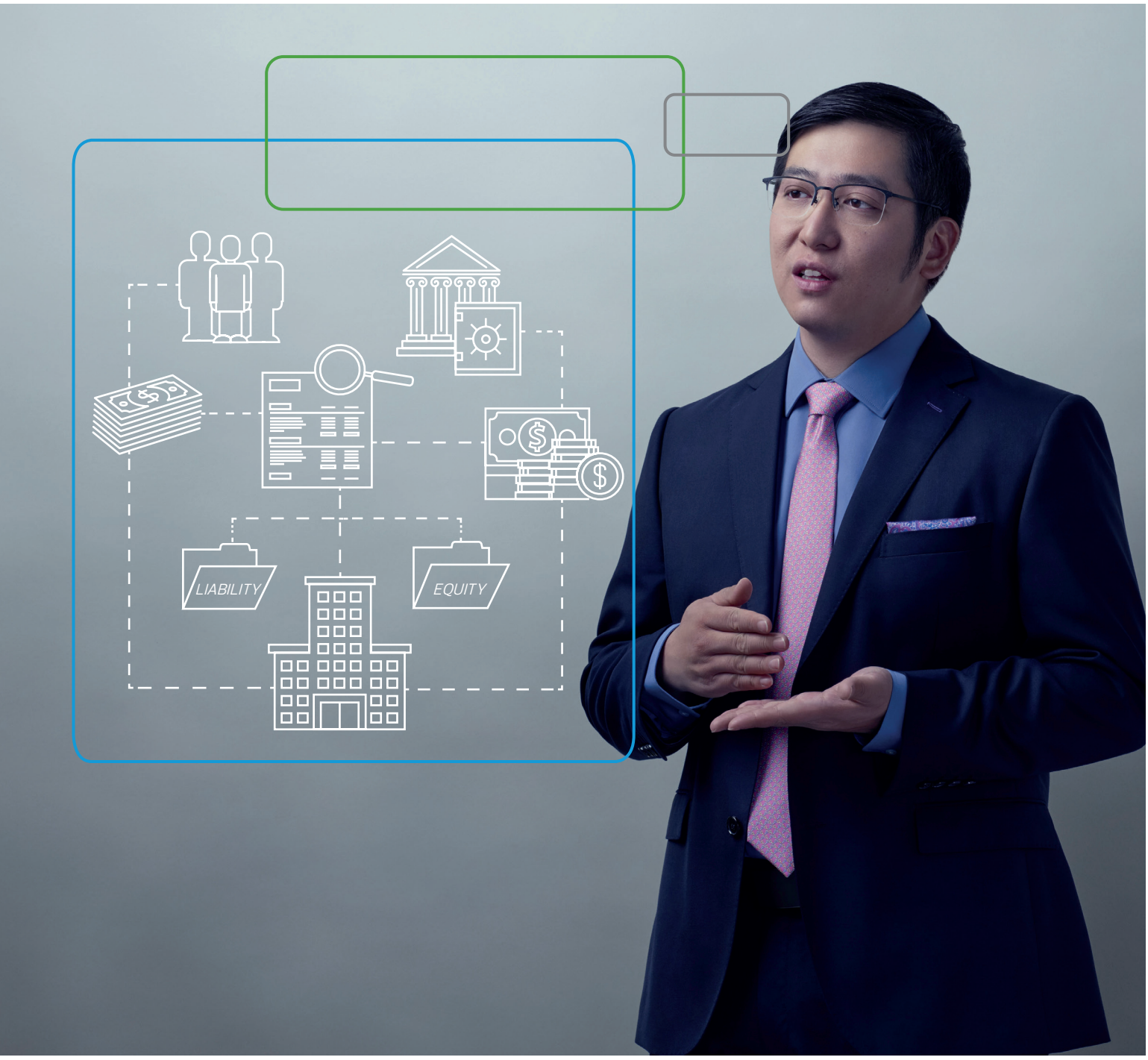

A GUIDE TO ACCOUNTING FOR DEBT AND EQUITY INSTRUMENTS IN FINANCING TRANSACTIONS

Fifth Edition

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FIFTH EDITION
March 2022

A GUIDE TO ACCOUNTING FOR DEBT AND EQUITY INSTRUMENTS IN FINANCING TRANSACTIONS

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Foreword

The accounting for debt and equity instruments issued in financing transactions can be quite complicated due in part to the complexity inherent in certain instruments, the sheer volume of transaction documents that may need to be considered in performing the accounting analysis and the myriad of accounting guidance that may be relevant. In many cases, an accounting outcome can be significantly affected by the existence or absence of one sentence in the relevant documents. Consideration needs to be given to not only the appropriate balance sheet classification of instruments such as preferred stock and warrants, which may have both debt and equity characteristics, but also the subsequent measurement. Additionally instruments such as debt or preferred stock oftentimes have embedded features that may need to be given separate accounting recognition. The accounting analysis is further complicated if multiple instruments are issued as part of the same transaction as that typically necessitates an allocation of proceeds to the various instruments or features.

This guide is intended to be a resource in understanding and analyzing some of the accounting guidance that may be relevant when analyzing debt and equity instruments issued in financing transactions and should be read in conjunction with the authoritative guidance. Given the complexity of instruments issued in financing transactions and the relevant accounting guidance, management may also want to consider seeking external expertise to assist in the accounting analysis. Appropriate upfront consideration to the accounting ramifications can help to minimize the risk of unanticipated and undesirable accounting consequences. Additionally, while valuation is beyond the scope of this guide, management should be mindful of the potential need to seek external expertise in developing the fair value estimates that may be necessary in appropriately accounting for certain instruments (or embedded features) issued in financing transactions.

For ease of use, definitions for acronyms and titles for ASC topics and subtopics and other literature referred to in this guide are included in Appendix A. In addition, several terms with specific meaning are used throughout this guide. Those terms and the corresponding definition are provided in Appendix B.

Important information about the scope of the guide

This guide is not intended to be a comprehensive manual as its content is limited to the accounting complexities associated with certain common instruments issued in financing transactions. The accounting analysis is from the issuer's perspective and differs significantly from an analysis that would be performed from the holder's perspective. This guide does not apply to share-based payments issued in exchange for goods and services within the scope of ASC 718.

Most recent updates to the guide

This guide has been updated to incorporate ASU 2020-06 and ASU 2021-04, as well as to address practice issues related to special-purpose acquisition companies (refer to Section 4.2.3.3.1, Section 5.2.2.1.3 and Section 5.2.2.2) and provide additional illustrations of the guidance relevant to determining whether an instrument (or embedded feature) is considered indexed to an entity's own stock (refer to Section 5.2.2.1.3).

The FASB issued ASU 2020-06, *Debt—Debt with Conversion and Other Options (Subtopic 470-20) and Derivatives and Hedging—Contracts in Entity's Own Equity (Subtopic 815-40): Accounting for Convertible Instruments and Contracts in an Entity's Own Equity*, to reduce complexities associated with the accounting for convertible instruments and the derivatives scope exception for contracts in an entity's own equity, the latter of which is the focus of Section 5.2.2 of this guide.

ASU 2020-06 is effective for public business entities that meet the definition of an SEC filer, excluding entities eligible to be smaller reporting companies as defined by the SEC and based on their most recent determination as of August 5, 2020, for fiscal years beginning after December 15, 2021, including interim periods within those fiscal years. For all other entities, the ASU is effective for fiscal years beginning after December 15, 2023, including interim periods within those fiscal years. Early adoption is permitted, but no

earlier than fiscal years beginning after December 15, 2020, including interim periods within those fiscal years. The changes to the accounting for convertible instruments and contracts in an entity's own equity as a result of ASU 2020-06 have been highlighted throughout this guide. Refer to Appendix C for additional information.

The FASB issued ASU 2021-04, *Earnings Per Share (Topic 260), Debt—Modifications and Extinguishments (Subtopic 470-50), Compensation—Stock Compensation (Topic 718), and Derivatives and Hedging—Contracts in Entity's Own Equity (Subtopic 815-40): Issuer's Accounting for Certain Modifications or Exchanges of Freestanding Equity-Classified Written Call Options (a consensus of the FASB Emerging Issues Task Force)*, to address the accounting for modifications or exchanges of equity-classified written call options that are freestanding and remain equity-classified. This guidance has been incorporated in Section 5.2.2.5 of this guide.

ASU 2021-04 is effective for all entities for fiscal years beginning after December 15, 2021, including interim periods within those fiscal years. Early adoption is permitted for all entities, including adoption in an interim period, with the guidance applied as of the beginning of the fiscal year that includes that interim period.

Content overview

Chapter 1: Accounting for the issuance of multiple instruments or embedded features

This chapter should be considered if multiple instruments are issued contemporaneously to the same counterparty or if certain features within a debt or preferred stock instrument require separate recognition. It addresses how to identify freestanding instruments from embedded features and how to allocate the proceeds to the various instruments or features. This chapter concludes with a section on registration rights agreements.

Chapter 2: Accounting for debt with conversion and other embedded features – After the adoption of ASU 2020-06

The focus of this chapter is the accounting for embedded features within debt instruments, including conversion, put and call options. Chapter 2 assumes the provisions of ASU 2020-06, which eliminates both the cash conversion model and the beneficial conversion feature model previously contained within ASC 470-20, have been adopted. This chapter also includes an illustration of interest expense recognition (including discount amortization) using the interest method. For guidance related to debt modifications and restructurings (which are beyond the scope of this guide), refer to our publication, A guide to accounting for debt modifications and restructurings (our debt modifications and restructurings guide).

Chapter 3: Accounting for debt with conversion and other embedded features – Before the adoption of ASU 2020-06

The focus of this chapter is the accounting for embedded features within debt instruments, including conversion, put and call options. Chapter 3 reflects the guidance applicable prior to the adoption of ASU 2020-06. This chapter also includes an illustration of interest expense recognition (including discount amortization) using the interest method. An exhibit at the end of this chapter provides a high-level overview of the accounting for a convertible debt instrument when (a) the conversion feature is required to be separately recognized as either (i) a derivative in accordance with ASC 815, (ii) a cash conversion feature in accordance with ASC 470-20 or (iii) a beneficial conversion feature in accordance with ASC 470-20, and (b) the conversion feature is not required to be separately recognized. For guidance related to debt modifications and restructurings (which are beyond the scope of this guide), refer to our debt modifications and restructurings guide.

Chapter 4: Accounting for preferred and similar stock

The focus of this chapter is preferred stock and similar instruments issued in the form of a share. The chapter addresses: (a) balance sheet classification and subsequent measurement, (b) the accounting for

common embedded features and (c) the accounting for conversions, modifications and redemptions. This chapter also addresses the accounting for delayed issuances of preferred or other stock and dividends on preferred stock. An exhibit at the end of this chapter provides a high-level overview of the accounting for convertible preferred stock when the conversion feature is required to be separately recognized as either a derivative in accordance with ASC 815 or, prior to adoption of ASU 2020-06, as a beneficial conversion feature in accordance with ASC 470-20, as well as when the conversion feature is not required to be separately recognized.

Chapter 5: Accounting for warrants and other equity-linked instruments

The focus of this chapter is determining the appropriate accounting treatment for freestanding instruments that are not in the form of shares, but are linked to shares. Examples may include warrants or forward contracts to purchase shares or freestanding options to redeem shares. This chapter also contains guidance on accelerated share repurchases.

Other RSM technical accounting guidance

As previously mentioned, guidance on the accounting for debt modifications and restructurings can be found in our debt modifications and restructurings guide. In addition, guidance on debt classification can be found in our publication, Fundamentals of debt classification. For a complete listing of our technical accounting guides and access to all of our financial reporting thought leadership, click here.

Chapter 1: Accounting for the issuance of multiple instruments or embedded features

1.1 Overview

It is common for stock offerings and debt issuances to involve multiple financial instruments contemporaneously issued to the same counterparty. This would be the case, for example, if warrants are issued to investors or lenders in conjunction with an equity or debt issuance. When multiple financial instruments are issued together, this generally necessitates allocating the proceeds received to each instrument to establish its initial carrying amount. The allocation will, in many cases, necessitate independent issuance-date estimates of fair value for each of the instruments issued in a bundled transaction. We believe this is typically the case even if specific proceeds were received for each instrument because any arbitrarily assigned prices for specific instruments may not be reflective of fair value. Not only is this allocation critical in establishing the initial carrying amount of each instrument, but it also has ongoing income statement repercussions resulting from factors such as the amortization or accretion of discounts or premiums created on debt, as well as the differing accounting treatment of costs incurred in a financing transaction.

Additionally, it is sometimes necessary to allocate proceeds and give separate recognition to embedded features within debt and equity instruments as elaborated on in Chapter 2, Chapter 3 and Chapter 4. A key first step in performing the accounting analysis and allocating proceeds is to identify what instruments are freestanding given that this determination impacts what accounting guidance is relevant and the instruments to which proceeds should be allocated. For example, a freestanding put option on an entity's shares would be analyzed in accordance with the chapter on equity-linked instruments and required to be accounted for as a liability under ASC 480-10-25-8, while a put option that is embedded in the underlying shares would be analyzed in the context of the chapter on preferred stock and is not subject to ASC 480-10-25-8. Similarly, when analyzing potential features under ASC 815 to determine if derivative recognition is required, there are additional considerations in ASC 815-15 that are relevant to embedded, but not freestanding, derivatives. To further complicate the analysis, the manner in which proceeds are allocated to each instrument is dependent on the required subsequent measurement for the instrument. Lastly, the determination of whether and to what extent separate recognition must be given to an embedded feature that is not freestanding can be impacted by the amount of proceeds allocated to the freestanding instrument.[1] The following steps, which are elaborated on in part in the table that follows and in part in other sections of this guide, are provided as a tool for structuring the accounting analysis when multiple financial instruments or embedded features are involved in a transaction.

Step	Relevant section in this guide
Identify the freestanding financial instruments	Section 1.2
Determine the accounting treatment for each freestanding financial instrument	Refer to the relevant chapters
Allocate the proceeds to each freestanding financial instrument	Section 1.3

[1] For example, prior to adoption of ASU 2020-06, the amount of proceeds allocated to a convertible instrument will impact if and to what extent a beneficial conversion feature exists under ASC 470-20 (see Section 3.4.2.1.2). Additionally, the amount of proceeds allocated to a debt host contract can impact whether an embedded put or call option requires separate recognition as a derivative (see Section 2.3.2.1 or Section 3.3.2.1, as applicable).

Step	Relevant section in this guide
Determine if any embedded features within each freestanding instrument require separate recognition	Section 2.3 for features that are embedded in a debt instrument, subsequent to adoption of ASU 2020-06 Section 3.3 for features that are embedded in a debt instrument, prior to adoption of ASU 2020-06 Section 4.3 for features that are embedded in preferred and similar stock
Allocate the proceeds to embedded features	Section 1.4 or Section 1.5, as applicable

1.2 Identify the freestanding financial instruments

The determination of what is freestanding versus embedded is sometimes straightforward and, in other circumstances, complex. Generally, if a financial instrument is not freestanding, it is embedded.

Understanding the terminology

The Master Glossary of the ASC defines a freestanding financial instrument as "A financial instrument that is either:

- Entered into separately and apart from any of the entity's other financial instruments or equity transactions, or
- Entered into in conjunction with some other transaction and is legally detachable and separately exercisable."

The Master Glossary defines an embedded derivative as "Implicit or explicit terms that affect some or all of the cash flows or the value of other exchanges required by a contract in a manner similar to a derivative instrument."

The following examples illustrate how common instruments or features are typically viewed; however, if facts and circumstances differ from those included in the examples, a different conclusion may be warranted.

Stock purchase warrants	Warrants are generally considered to be freestanding even if issued with another financial instrument, such as debt or stock, because typically warrants are separately exercisable (i.e., the exercise of the warrants would not result in the termination of the debt or stock the warrants may have been issued with). If, on the other hand, the warrants are not detachable from another instrument, such as debt that must be surrendered to exercise the warrants, as noted at ASC 470-20-25-3, the warrants would be considered embedded in the convertible instrument and the following discussion on conversion options applies.
Conversion options in debt or preferred stock	Conversion options are typically viewed as embedded in the convertible debt or preferred stock instruments given that the conversion option generally cannot be detached and separately exercised (i.e., the exercise of the conversion option would result in the termination of the debt or preferred stock that is converted).
Put and call options related to debt and equity instruments	Put and call options are most commonly considered to be embedded because: (a) the options are typically entered into in

	conjunction with the issuance of the debt or equity instrument, (b) the options cannot be transferred separately from the underlying debt or equity instrument, and (c) the exercise of the option will result in the termination or redemption of the underlying debt or equity instrument.

1.3 Allocate the proceeds to each freestanding financial instrument

The appropriate method to use in allocating proceeds to each freestanding financial instrument depends on whether any of the instruments will be subsequently measured at fair value (through a fair value election or requirement). Instruments such as liability warrants that will be subsequently measured at fair value are generally allocated proceeds equal to their issuance-date fair value. Any remaining proceeds are then allocated to instruments that are not subsequently measured at fair value based on each instrument's proportionate fair value to the total fair value of instruments not subsequently measured at fair value. An example follows.

Example: Allocating proceeds to debt and warrants

Debt and warrants are issued as part of the same transaction for total proceeds of $1 million. The allocation of proceeds under two different scenarios follows. For each of these scenarios, assume that the fair value of the debt is $1 million and that the fair value of the warrants is $200,000. Assume also that the debt will not subsequently be measured at fair value (through an election or otherwise).

Scenario 1: Warrants meet the requirements to be classified as equity and therefore will not be subsequently measured at fair value

	Fair value	Allocated proceeds and initial carrying amount	
Debt	$1,000,000	$833,333	(a)
Warrants	200,000	166,667	
Total	$1,200,000	$1,000,000	

(a) Represents the net amount. Assuming the face amount is $1 million, this would be recorded as $1 million of debt with a discount of $166,667.

In this scenario, because ongoing fair value measurement is not required for any instrument, the proceeds are allocated to each financial instrument based on the respective instrument's proportionate fair value (allocated proceeds = instrument fair value ÷ total fair value x total proceeds) in accordance with ASC 470-20-25-2.

Scenario 2: Warrants are classified as a liability and are subsequently measured at fair value

	Fair value	Allocated proceeds and initial carrying amount	
Debt	$1,000,000	$800,000	(a)
Warrants	200,000	200,000	
Total	$1,200,000	$1,000,000	

(a) Represents the net amount. Assuming the face amount is $1 million, this would be recorded as $1 million of debt with a discount of $200,000.

In this scenario, because ongoing fair value measurement is required for the warrants, the proceeds are allocated to the warrants in an amount equal to their fair value. The remaining proceeds would then be allocated to the instruments that are not accounted for at fair value based on their relative fair values. In this example, the debt is the only other freestanding instrument. It should be noted that any

discounts (such as the $200,000 in Scenario 2) or premiums on debt (and mandatorily redeemable stock that is accounted for as a liability) that are created through an allocation of the proceeds (or otherwise) are amortized or accreted into interest expense using the interest method described in ASC 835-30 (refer to the illustration at Section 2.6 or Section 3.5, as applicable). Similarly, discounts on redeemable preferred stock are accreted as dividends (assuming the preferred stock is not classified as a liability) as elaborated on in Section 4.2.3.3.

In addition to allocating proceeds, we believe it is also appropriate to allocate issuance costs that are not specifically associated with one of the financial instruments to each of the freestanding financial instruments. There is no specific guidance that addresses how such issuance costs should be allocated. Methods employed in practice include allocating costs to each instrument in the same proportion as how the proceeds are allocated to each instrument or allocating the costs to each instrument based on the relative proportion of costs that would be incurred in issuing each instrument separately. Depending on the facts and circumstances, a different approach may be justifiable. For example, in a transaction involving only debt and warrants, if the warrants are issued solely as an incentive to obtain debt financing, it may be appropriate to treat all issuance costs as debt issuance costs. An appropriate allocation of costs is important as the accounting treatment for the costs differs significantly depending on the accounting treatment for the instrument, in that:

- Costs associated with debt (including mandatorily redeemable stock classified as a liability) are amortized over the life of the debt using the interest method.
- Costs associated with temporary-equity-classified preferred stock are netted against the proceeds and can impact the amount of dividend recognized as the preferred stock is accreted to its redemption amount.
- Costs associated with equity instruments (including warrants that qualify for equity treatment) are netted against the proceeds received in equity.
- Costs associated with warrants that are required to be accounted for as liabilities at fair value are expensed as incurred.

For this reason, it is important to use an approach that is rational in the circumstances and consistently applied.

When using the relative fair value approach to allocate proceeds, there will be no effect on the income statement on the issuance date. However, if the aggregate fair value of instruments that will be subsequently measured at fair value exceeds the total proceeds received, it is possible that there could be a loss (or, in rare cases, a dividend) recorded on the date of the transaction. This is because the amount assigned to the remaining instruments that are not recorded at fair value (the debt in the earlier examples) generally cannot be less than zero. Refer to Remarks by Hillary H. Salo, Professional Accounting Fellow, Office of the Chief Accountant, at the AICPA National Conference on Current SEC and PCAOB Developments – 2014 for a more in-depth discussion of this matter. When fact patterns like this are present, it is particularly important to understand the underlying economics of the transaction, challenge the valuation of the individual financial instruments (given the counterintuitive results), and also consider if there are additional rights or obligations requiring separate accounting. We expect this situation to be rare.

The earlier examples should serve to illustrate why it is necessary to identify the freestanding financial instruments and determine their appropriate balance sheet classification and subsequent measurement before allocating the proceeds. It should also be evident from these examples that it may be necessary for management to develop or obtain fair value estimates for certain, or all, of the multiple freestanding financial instruments issued as part of the same transaction to appropriately allocate the proceeds.

1.4 Allocate the proceeds to embedded features – After adoption of ASU 2020-06

In addition to allocating the proceeds to each freestanding financial instrument when multiple financial instruments are issued together, it is sometimes necessary to allocate a portion of the proceeds attributable to a freestanding financial instrument to certain embedded features that require separate recognition as discussed in Chapter 2 for debt and Chapter 4 for preferred and similar stock. Common examples of embedded features that may require separate recognition as derivatives include conversion options and puts and calls.

Derivatives requiring separate recognition are reported on the balance sheet as an asset or a liability, and initially and subsequently are measured at fair value. Generally, the initial carrying amount is established through an allocation of proceeds, and subsequent changes in fair value are recognized through earnings.

Once the amount of proceeds to be allocated to features requiring separate recognition is known, any remaining proceeds that were received or attributed to the debt or equity instrument as a whole establish the initial carrying amount of the remaining debt or equity instrument. An illustration follows.

Example: Allocating proceeds to embedded features and freestanding instruments

Assume the debt in Scenario 2 of the example presented earlier contains a conversion option with a fair value of $200,000 that requires separate recognition as a derivative. In this situation, $200,000 of the $800,000 allocated to the debt would be allocated to the conversion option derivative liability. The net-of-discount carrying amount of the debt would be the remaining $600,000. The entry to record this transaction would be:

	Debit	Credit
Cash	$1,000,000	
Discount on debt	400,000	
Derivative liability		$200,000
Debt		1,000,000
Warrant liability		200,000

As previously mentioned, discounts (such as the one in this example) or premiums on debt or certain redeemable preferred stock that are created through an allocation of the proceeds (or otherwise) are amortized or accreted into interest expense or dividends using the interest method illustrated in Section 2.6.

With respect to embedded derivatives that require separate recognition, the following additional considerations should be kept in mind:

- When determining the fair value of an embedded derivative that requires separate recognition, the objective is to estimate its fair value separately from the fair value of the nonderivative portions of the instrument in which it is embedded.
- If more than one derivative embedded in an instrument requires separate recognition, those derivatives should be bundled together and treated as one derivative.
- If an embedded non-option derivative, such as a mandatory conversion feature, requires separate recognition, the terms for that non-option derivative should be calibrated to result in a fair value of zero at the issuance date in accordance with ASC 815-15-30-4. Conversely, as noted in ASC 815-15-30-6, the terms should not be adjusted for an option-based derivative, regardless of whether the option is in or out of the money at the issuance date.

- While embedded derivatives that are bifurcated require separate measurement at fair value and are subject to the derivative disclosure requirements, in practice, the recorded balance is typically reported in the same financial statement line item as the host contract if the host contract is an asset or liability. (It would not be appropriate to combine a derivative asset or liability with a host contract that is classified in equity.)
- As an alternative to separately recognizing embedded derivatives that require bifurcation at fair value, an entity may be able to make an election as outlined beginning at ASC 815-15-25-4 to account for the entire instrument at fair value.

1.5 Allocate the proceeds to embedded features – Prior to adoption of ASU 2020-06

In addition to allocating the proceeds to each freestanding financial instrument when multiple financial instruments are issued together, it is sometimes necessary to allocate a portion of the proceeds attributable to a freestanding financial instrument to certain embedded features that require separate recognition as elaborated on in Chapter 3 for debt and Chapter 4 for preferred and similar stock. Examples of common embedded features that may require separate recognition are summarized in the table that follows along with the balance sheet classification and measurement provisions.

Feature	Balance sheet classification	Measurement
Beneficial conversion feature	Equity	Generally, commitment date intrinsic value without subsequent remeasurement (refer to Section 3.4.2).
Cash conversion feature	Equity	The excess of the proceeds ascribed to the convertible debt instrument as a whole over the fair value of a similar liability that does not have an equity component. This amount is generally not subsequently remeasured (refer to Section 3.4.1).
Derivatives, including conversion options, puts and calls	Asset or liability	Initial and subsequent measurement is fair value. Generally, the initial carrying amount is established through an allocation of proceeds, and subsequent changes in fair value are recognized through earnings.

Once the amount of proceeds to be allocated to features, such as those summarized in the preceding table is known, any remaining proceeds that were received or attributed to the debt or equity instrument as a whole establish the initial carrying amount of the remaining debt or equity instrument. An illustration follows.

Example: Allocating proceeds to embedded features and freestanding instruments

Assume the debt in Scenario 2 of the example presented earlier contains a conversion option with a fair value of $200,000 that requires separate recognition as a derivative. In this situation, $200,000 of the $800,000 allocated to the debt would be allocated to the conversion option derivative liability. The net of discount carrying amount of the debt would be the remaining $600,000. The entry to record this transaction would be:

	Debit	Credit
Cash	$1,000,000	
Discount on debt	400,000	
Derivative liability		$200,000
Debt		1,000,000
Warrant liability		200,000

As previously mentioned, discounts (such as the one in this example) or premiums on debt or certain redeemable preferred stock that are created through an allocation of the proceeds (or otherwise) are amortized or accreted into interest expense or dividends using the interest method illustrated at Section 3.5.

The following additional considerations should be kept in mind as it relates to embedded derivatives that require separate recognition:

- The objective when determining the fair value of an embedded derivative that requires separate recognition is to estimate its fair value separately from the fair value of the nonderivative portions of the instrument in which it is embedded.
- If more than one derivative embedded in an instrument requires separate recognition, those derivatives should be bundled together and treated as one derivative.
- If an embedded non-option derivative, such as a mandatory conversion feature, requires separate recognition, the terms for that non-option derivative should be calibrated to result in a fair value of zero at the issuance date in accordance with ASC 815-15-30-4. Conversely, as noted at ASC 815-15-30-6, the terms should not be adjusted for an option-based derivative, regardless of whether the option is in or out of the money at the issuance date.
- While embedded derivatives that are bifurcated require separate measurement at fair value and are subject to the derivative disclosure requirements, in practice, the recorded balance is typically reported on the same financial statement line item as the host contract if the host contract is an asset or liability. (It would not be appropriate to combine a derivative asset or liability with a host contract that is classified in equity.)
- As an alternative to separately recognizing embedded derivatives that require bifurcation at fair value, an entity may be able to make an election as outlined beginning at ASC 815-15-25-4 to account for the entire instrument at fair value.

1.6 Registration payment arrangements

1.6.1 Definition and scope

It is not uncommon for companies to extend registration rights to their shareholders or potential shareholders in conjunction with an equity offering or the issuance of warrants or convertible debt. ASC 825-20 provides guidance on how to account for those arrangements that meet the definition of a registration payment arrangement, which would be the case if both of the following characteristics exist:

- The arrangement specifies that the issuer will either endeavor to: (a) file a registration statement for the resale of specified financial instruments and (or) the resale of equity shares that are issuable upon exercise or conversion of specified financial instruments, and for that registration statement to be declared effective by the SEC (or other applicable securities regulator if the registration statement will be filed in a foreign jurisdiction) within a specified grace period, and (or) (b) maintain the effectiveness of the registration statement for a specified period of time (or in perpetuity).

- The arrangement requires the issuer to transfer consideration to the counterparty if the registration statement is not declared effective or if effectiveness of the registration statement is not maintained. The form of the consideration and timing of payment can vary. For example, the consideration may be in the form of cash, equity instruments or adjustments to the terms of the financial instrument or instruments that are subject to the registration payment arrangement (such as an increased interest rate on a debt instrument).

This guidance applies to a registration payment arrangement regardless of whether it is issued as a separate agreement or included as a provision of a financial instrument or other agreement. Additionally, an arrangement that requires the issuer to obtain and (or) maintain a listing on a stock exchange (instead of, or in addition to, obtaining or maintaining an effective registration statement) is also within the scope of ASC 825-20 if the earlier definition is met.

As outlined at ASC 825-20-15-4, this guidance does not apply to any of the following:

- Arrangements that require registration or listing of convertible debt instruments or convertible preferred stock if the form of consideration that would be transferred to the counterparty is an adjustment to the conversion ratio
- Arrangements in which the amount of consideration transferred is determined by reference to either an observable market (other than the market for the issuer's stock) or an observable index
- Arrangements in which the financial instrument or instruments subject to the arrangement are settled when the consideration is transferred (e.g., a warrant that is contingently puttable if an effective registration statement for the resale of the equity shares that are issuable upon exercise of the warrant is not declared effective by the SEC within a specified grace period)

Additionally, as noted at ASC 825-20-15-5, this guidance should not be applied by analogy to the accounting for contracts that are not registration payment arrangements as defined earlier.

1.6.2 Recognition and measurement

In accordance with ASC 825-20-25, registration payment arrangements within the scope of ASC 825-20 should be recognized as a separate unit of account from the financial instrument or instruments that are subject to the arrangement. Additionally, the financial instruments that are subject to the arrangement should be recognized in accordance with relevant U.S. GAAP without regard to any contingent obligation to transfer consideration under the registration payment arrangement. ASC 450-20 should be followed in determining the appropriate recognition and measurement for the contingent obligation. As a result, if at the inception of the arrangement, the transfer of consideration is probable and can be reasonably estimated, a liability for this obligation would be established in accordance with ASC 450-20, and any remaining proceeds from the related financing transaction would be allocated to the financial instrument or instruments issued in conjunction with the registration payment arrangement in accordance with the provisions of this chapter. ASC 825-20-30-5 provides that for arrangements that require payment in shares, if the transfer of consideration is probable and the number of shares to be delivered can be reasonably estimated, the share price at the reporting date should be used in measuring the contingent liability.

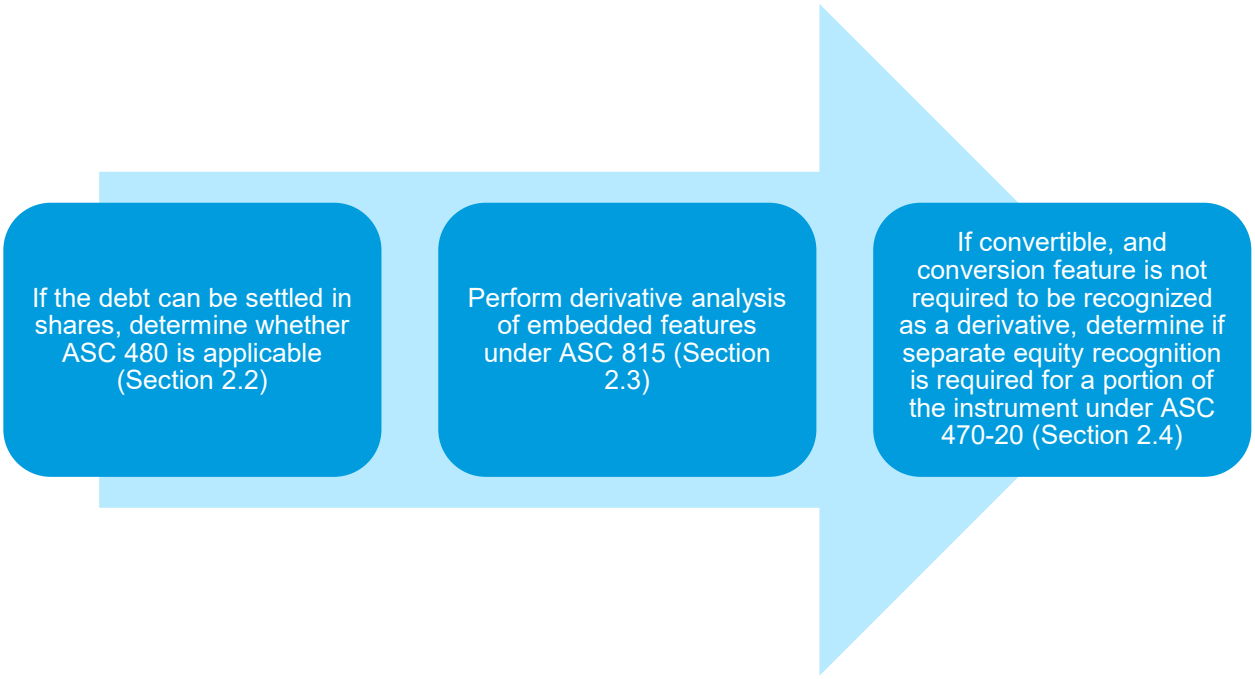
If after the inception of the arrangement, the transfer of consideration becomes probable and can be reasonably estimated such that a liability needs to be newly recognized, this liability would be recognized as an expense. Similarly, any adjustments to the carrying amount are also recognized in earnings. Examples are included in ASC 825-20-55 that illustrate the application of this guidance.

Chapter 2: Accounting for debt with conversion options and other embedded features – After adoption of ASU 2020-06

2.1 Introduction

This chapter assumes ASU 2020-06 has been adopted. Chapter 3 addresses the accounting for debt with conversion options prior to the adoption of ASU 2020-06. Refer to Appendix C for additional information on ASU 2020-06.

The accounting for debt with conversion options and other embedded features, such as put and call options, necessitates giving consideration to: (a) ASC 480 to determine if the debt is within its scope, (b) ASC 815 to determine whether any of the features embedded in the debt agreement need to be separately recognized as a derivative, and (c) ASC 470-20 for convertible debt issued at a substantial premium for which the conversion feature does not require derivative accounting to determine whether the premium needs to be recognized as a separate component of equity.



Sections 2.2 through 2.4 of this chapter summarize the accounting analysis necessary to make these determinations and the resulting ramifications. Section 2.5 addresses derecognition of convertible debt in various scenarios, and Section 2.6 includes an illustration of interest expense recognition, including discount amortization, using the interest method. Guidance related to debt modifications and restructurings can be found in our debt modifications and restructurings guide.

2.2 ASC 480 considerations – After adoption of ASU 2020-06

While a debt instrument should be classified as a liability regardless of whether ASC 480 applies, if a debt instrument may be settled in shares, consideration should be given to ASC 480-10-25-14, because, if applicable, this could impact the measurement of the instrument and the relevant disclosure requirements. Specifically, a debt instrument that embodies a conditional or unconditional obligation that the issuer must or may settle by issuing a variable number of its equity shares would be subject to ASC 480 if, at inception, the monetary value of the obligation is based solely or predominantly on any one of the following criteria (referred to for the remainder of this section as the three criteria):

1. A fixed monetary amount known at inception (e.g., a payable settled with the number of issuer's equity shares required to equate to a fixed amount of value)
2. Variations in something other than the fair value of the issuer's equity shares (e.g., a financial instrument indexed to the Standard & Poor's 500 index and settled with a variable number of the issuer's equity shares)
3. Variations inversely related to changes in the fair value of the issuer's equity shares (e.g., a written put option that could be net share settled)

Understanding the terminology

The following are key terms used in ASC 480-10, along with their definitions from the Master Glossary of the ASC:

- **Monetary value**: "What the fair value of the cash, shares, or other instruments that a financial instrument obligates the issuer to convey to the holder would be at the settlement date under specified market conditions."
- **Obligation**: "A conditional or unconditional duty or responsibility to transfer assets or to issue equity shares."

Generally, instruments that are convertible to shares at the holder's option are not subject to ASC 480. However, a debt instrument that must or may be settled in a variable number of the issuer's equity shares (through conversion or otherwise) may be subject to ASC 480 if it meets any of the three criteria. An example of an instrument that may meet the first criterion is a debt instrument that will be settled in a variable number of shares, with that number to be determined based on 80 percent of the conversion date fair value of a share (i.e., a 20 percent discount). In this case, the holder receives the same value regardless of the share price at the time of the conversion. For example, if the face amount of the debt was $1 million and the share price was $6 at the time of conversion, the holder would receive 208,333 shares ($1 million face amount divided by 80 percent of the $6 share price) worth $6 each for an extended value of $1.25 million. If the share price was $7 at the time of conversion, the holder would receive 178,571 shares ($1 million face amount divided by 80 percent of the $7 share price) worth $7 each for the same extended value of $1.25 million.[2]

An instrument that meets criterion one would generally be accounted for as stock-settled debt (which entails accreting the carrying amount up to the $1.25 million settlement amount in the preceding example through the settlement date in accordance with the interest method illustrated at Section 2.6) if the monetary value of the obligation is based solely or predominantly on a fixed settlement amount. Other instruments that fall within the scope of ASC 480 by meeting the second or third criterion may necessitate subsequent measurement at fair value under ASC 480-10-35-5 unless another subtopic of U.S. GAAP specifies a different measurement attribute.

The analysis of whether a debt instrument is within the scope of ASC 480 becomes more complex when the monetary value is in part, but not solely, based on one of the three criteria. Subjectivity comes into play in determining if the monetary value is based predominantly on one of these criteria as predominantly is not defined in ASC 480. We are aware of divergent views in practice as to whether

[2] As noted in the footnote to the section that follows, some bridge notes are settled in a variable number of shares upon the occurrence of a qualified financing event, with the number of shares determined based on the price at which shares are issued in the financing event. These instruments are generally not viewed as subject to ASC 480-10-25-14 unless an obligation exists at the issuance date to conduct a qualified financing event, and settlement in a manner that meets the first criterion is deemed to be predominant at the issuance date.

predominant should be interpreted as more likely than not or a higher threshold, such as 90 percent as suggested by the use of the words "in small part" in ASC 480-10-55-22. Other examples in ASC 480-10-55 may also be useful in making this determination. In the context of the example in the preceding paragraph, if the number of shares to be issued is determined based on an average share fair value over a stated period of time (e.g., 30 days before settlement) rather than the fair value of the shares on the conversion date, based on the example at ASC 480-10-55-22, a conclusion would be reached that while the monetary value is in small part based on variations in the fair value of the shares that can occur during the 30 day period, the monetary value is predominantly fixed such that the first criterion would be met.

In circumstances involving multiple potential settlement outcomes, the analysis becomes even more complex as it is necessary to assess as of the issuance date which outcome is predominant. In the preceding example, the debt will settle in shares at a discount to the conversion date fair value (a situation that may meet the first of the three criteria). If the debt in that example was also convertible at the holder's option into a fixed number of shares or could be settled in cash upon its maturity (two alternatives that would not meet any of the three criteria), the reporting entity would need to determine if an outcome that meets one of the criteria is predominant. In making this determination, consideration should be given to all pertinent information, such as the current stock price and volatility, the strike price of the instrument and any other relevant factors to determine if, for example, it would be more advantageous for the holder to elect to convert to the fixed number of shares. If settlement in a manner that meets one of the three criteria is determined to be predominant, the instrument is accounted for in accordance with ASC 480. If not, the feature that could result in the issuance of a variable number of shares is evaluated to determine if it should be separately recognized as a derivative as discussed in the next section.

2.3 Derivative analysis of embedded features – After adoption of ASU 2020-06

2.3.1 Overview

It is common for debt instruments to have embedded features that may require separate recognition as derivatives, including conversion options, early redemption features (such as put and call options), additional payments if a contingent event such as a change in control occurs, and interest that is indexed to something other than interest rates. While the focus of this section is on the features we have most commonly observed in practice, there may be other features within a debt instrument that necessitate similar consideration of the guidance that follows. The focus should be on features that can alter the amount or timing of cash flows or the value of other exchanges (e.g., conversion shares).

Distinguishing between conversion and redemption options

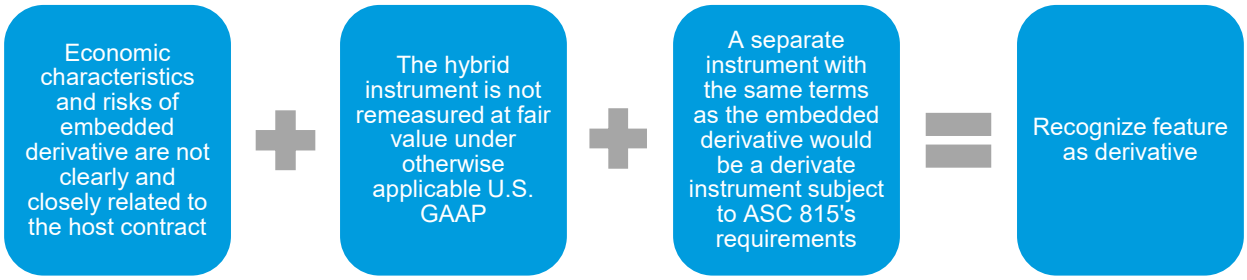
Standard conversion options allow for conversion of the debt into a fixed or substantially fixed number of shares. Standard redemption features, such as put and call options, give the holder the right to put the debt to the issuer (or the issuer the right to call the debt from the holder) at a stated amount to be paid in cash or shares. Some instruments provide for conversion into a variable number of shares, with the number of shares determined at the time of conversion based on the fair value of the shares at the conversion date. Such a feature is designed to ensure that the holder receives a predetermined amount of value paid in whatever number of shares it takes to arrive at that value.[3] In other words, the

[3] We have observed several variations of debt instruments in practice (typically bridge financing notes) that contractually convert into the class of shares issued in the next qualified financing event (as defined in the agreement) at the price at which shares are issued in the financing event, or a percentage of that price (e.g., 80% of the qualified financing price). Generally, such features are evaluated as a redemption option rather than a conversion option, assuming that the qualified financing event is defined in a manner that one would expect the shares to be issued at a price reflective of fair value, such that the feature is designed to give the debt holders a fixed amount of

value that the holder is expected to receive upon conversion is not expected to vary based on changes in the value of the underlying shares. Assuming that this feature does not result in classification as stock-settled debt as discussed at Section 2.2, we believe it would be appropriate to analyze this feature as a redemption option rather than a conversion option in the analysis that follows to determine when certain embedded features must be separately recognized as derivatives.

The determination of which, if any, embedded features must be separately recognized as derivatives is complex. Specifically, ASC 815-15-25-1 requires derivative recognition for embedded features if all of the following three criteria are met:

1. The economic characteristics and risks of the embedded derivative are not clearly and closely related to the economic characteristics and risks of the host contract.
2. The hybrid instrument is not remeasured at fair value under otherwise applicable U.S. GAAP.
3. A separate instrument with the same terms as the embedded derivative would be a derivative instrument subject to the requirements of ASC 815 (i.e., it meets the definition of a derivative and does not qualify for one of the scope exceptions outlined at ASC 815-10-15-13).



2.3.2 Application of the embedded derivatives guidance to common features in debt instruments – After adoption of ASU 2020-06

Criteria 1 and 3 are discussed in more depth in the sections that follow. Regarding Criterion 2, if the debt instrument qualifies, and the reporting entity elects to account for it at fair value or the instrument is required to be accounted for at fair value on an ongoing basis, no embedded derivatives would require separate recognition, and the embedded derivative analysis is not relevant.

2.3.2.1 Criterion 1

The first criterion to consider in the embedded derivative analysis is whether the economic characteristics and risks of the embedded derivative are clearly and closely related to the economic characteristics and risks of the host contract. Instruments issued in financing transactions are analyzed to determine whether the host contract is more debt-like or equity-like. This analysis is based on all stated and implied substantive terms and features, with each term and feature evaluated and weighted to determine if a specific instrument is more debt-like or equity-like. Instruments issued in the legal form of debt, as well as certain preferred or other stock that have strong debt-like characteristics, are generally considered to have a debt host contract (refer to Section 4.3.2.1 for the determination of the nature of the host contract for preferred stock and similar instruments issued in the form of a share). The primary economic

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value paid in a variable number of shares. (That may not be the case if the financing event is defined to be substantially based on the exercise or conversion of preexisting warrants or convertible instruments at preestablished contractual strike prices). In some cases, there may be multiple conversion features or optionality in the conversion price (i.e., the debt will convert at the lower of a predefined price or a predefined percentage of the qualified financing price), in which case, the instrument may contain both a conversion option and a redemption option.

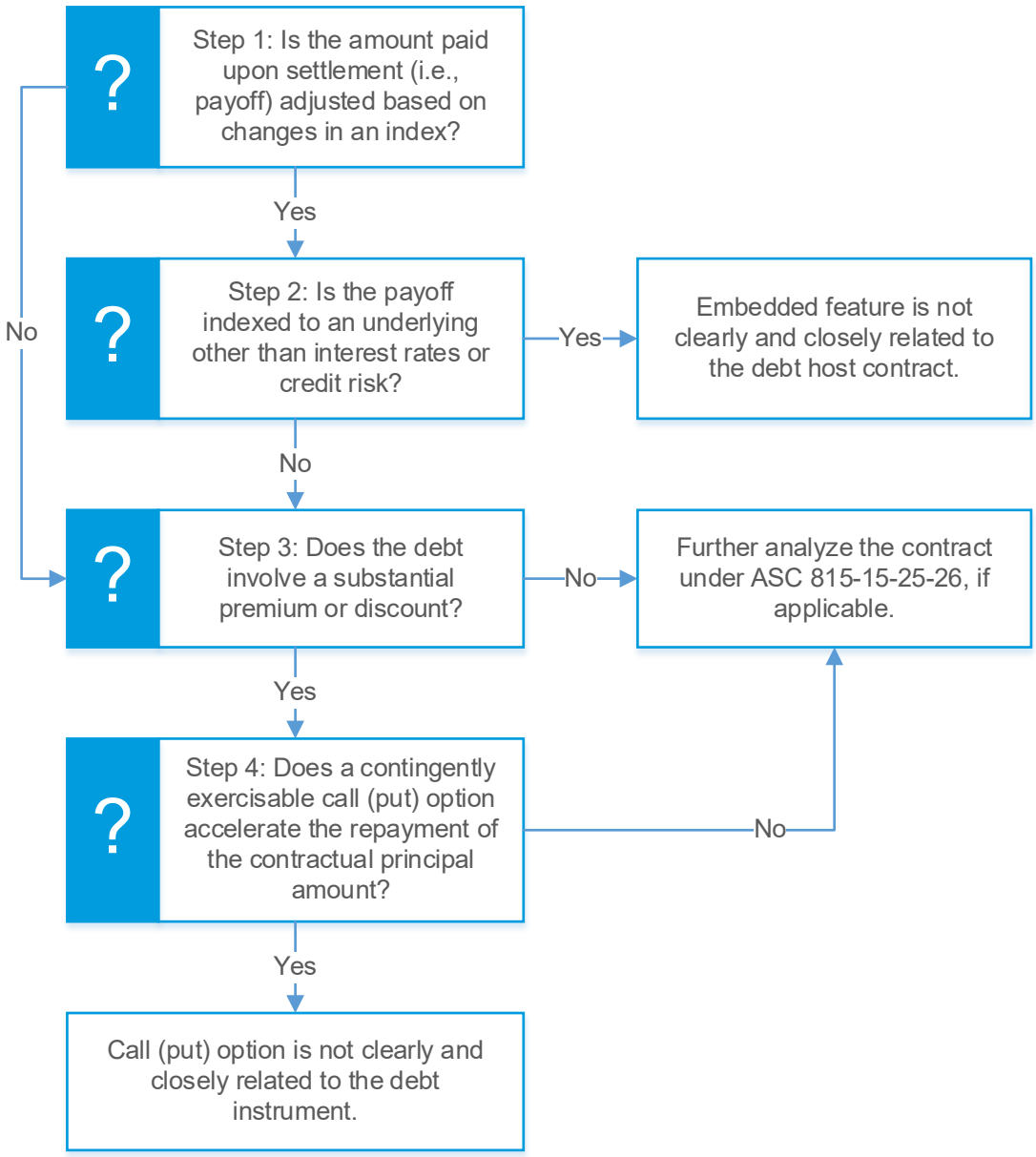
characteristics and risks associated with a debt host are interest rates, inflation and credit risk. As pointed out at ASC 815-15-25-51, equity conversion options are not clearly and closely related to a debt host contract because their underlying value is dependent upon the value of an equity interest. As it relates to redemption features within debt instruments that can accelerate repayment (whether in cash or shares), such as put and call options, additional analysis is necessary to determine if a particular feature is clearly and closely related to the debt host contract. Specific guidance relevant to this determination is primarily found in ASC 815-15-25-26 and ASC 815-15-25-42.

The guidance in ASC 815-15-25-26 does not apply if there is an underlying related to the put or call option other than interest rates or an interest rate index. If, for example, a put or call option can only be exercised upon the occurrence of a contingent event, which is another underlying, this guidance is not relevant.

The guidance on put and call options at ASC 815-15-25-42 outlines a four-step decision sequence that should be followed in determining whether options that can accelerate the settlement of debt instruments are clearly and closely related to the debt host contract. This decision sequence results in a conclusion that put and call options are not clearly and closely related under any of the following circumstances:

- Rather than being the repayment of principal at par, the payoff amount is indexed to something other than interest rates or credit risk.
- The debt involves a substantial premium or discount and the option is contingently exercisable.
- One of the two conditions outlined later in this section from ASC 815-15-25-26 are met, if applicable.

The four-step decision sequence in ASC 815-15-25-42 follows on the next page.



An example of the type of put or call option that we have observed most frequently in practice that is not clearly and closely related to the debt host contract is a feature that will result in payment of the debt at a significant premium upon the occurrence of a contingent event, such as a change in control. When considering Steps 1 and 2 of the decision sequence, we believe repayments that are based on either a fixed premium to par or a premium that changes due to the passage of time would not be considered indexed to something other than interest rates or credit risk. In evaluating the significance of a premium or discount in Step 3, in practice, premiums or discounts of 10 percent or more are generally viewed as substantial; however, consideration should be given to the specific facts and circumstances. Additionally, we believe that when determining if the debt involves a substantial premium or discount, consideration should be given to not only the relationship of the par amount to the issuance proceeds attributable to the debt, but also to the relationship of the payoff amount to the issuance proceeds attributable to the debt. As such, even when debt is issued at par, but a portion of the proceeds is allocated to other freestanding instruments (such as warrants) in accordance with Chapter 1, the debt could be deemed to involve a

substantial discount. Generally, it would not be appropriate to consider discounts created by separately recognizing a conversion option associated with the debt, given that typically the holder would not benefit from the conversion option if the instrument is redeemed. However, it may be necessary to consider premiums or discounts created from bifurcating other embedded derivatives from the debt that could result in payments that are incremental to the redemption feature and can be triggered prior to or on the redemption date. Additionally, while fees paid to the creditor can create a discount that would be considered in this analysis, discounts related to issuance costs paid to third parties would be ignored in this analysis.

The guidance in ASC 815-15-25-26 is relevant to the analysis of noncontingent puts and calls and other features in a debt instrument that can alter the interest payments if the only underlying in the potential derivative is an interest rate or interest rate index. (As mentioned earlier, keep in mind that if exercise of the option is contingent on the occurrence of a certain event, such as a change in control, this would constitute a non-interest rate underlying and, as such, ASC 815-15-25-26 would not be relevant to the analysis for that option.) When applicable, a conclusion would be reached under ASC 815-15-25-26 that an embedded feature is clearly and closely related to a debt host contract unless one of the following two conditions exists:

- There is a possible situation in which the creditor could be forced by the terms of the debt instrument to accept settlement in such a way that it would not recover substantially all of its initial recorded investment. (In practice, substantially all has generally been interpreted to mean at least 90 percent.) An example of when this condition would exist includes a situation whereby debt is issued at a premium greater than 10 percent and gives the debtor the option of prepaying at par.
- There is a possible future interest rate scenario under which the embedded derivative would at least double the creditor's initial rate of return on the debt instrument and result in a rate of return that would be at least twice the then-current market rate of return for a debt instrument with the same terms involving a debtor with similar credit quality at the inception of the debt. This condition does not apply if the right to accelerate the payment of the debt can only be exercised by the debtor.

In determining whether either of the two conditions exists, keep in mind that the analysis should be performed after allocating the proceeds to freestanding financial instruments that may have been issued together in the same transaction, such as warrants and debt.

Examples are provided at ASC 815-15-55-13 and ASC 815-15-55-25 to illustrate whether embedded put and call options are clearly and closely related to debt host contracts.

2.3.2.2 Criterion 3

The third criterion in the embedded derivative analysis necessitates determining if a separate instrument with the same terms as the embedded derivative would be a derivative instrument subject to the requirements of ASC 815. Addressing this criterion involves determining if the embedded feature meets the definition of a derivative as outlined beginning at ASC 815-10-15-83, and if so, whether it qualifies for one of the scope exceptions outlined at ASC 815-10-15-13.

Understanding the terminology

By definition, a derivative instrument has all of the following characteristics:

- One or more underlyings
- One or more notional amounts or payment provisions
- Requires no initial net investment or an initial net investment that is smaller than would be required for other types of contracts that would be expected to have a similar response to changes in market factors

- The contract can be settled net by any of the following means:
  - Its terms implicitly or explicitly require or permit net settlement.
  - It can readily be settled net by a means outside the contract.
  - It provides for delivery of an asset that puts the recipient in a position not substantially different from net settlement.

While an in-depth discussion of derivatives is beyond the scope of this guide, the following chart provides an indication of whether each characteristic would likely be met for standard conversion and redemption options in debt instruments or debt host contracts.

Characteristic	Conversion option	Redemption option
Underlying	Yes, fair value of the shares into which it can be converted	Yes, the fair value of the debt host, which is a function of interest rates and credit risk. Additionally, if exercise of the option is contingent, the occurrence of the contingent event would also constitute an underlying.
Notional amount or payment provision	Yes, number of shares into which it can be converted	Yes, face or payoff amount
No or smaller initial net investment	Yes, the fair value (i.e., initial net investment) of the conversion option at inception is generally less than the fair value of the underlying shares.	Yes, the fair value (i.e., initial net investment) of the redemption option at inception is generally less than the fair value of the underlying debt.
Net settlement	Yes, if the conversion shares are readily convertible to cash or contractually the conversion option can be settled net	Yes, due to ASC 815-10-15-107[4]
Scope exception that may be relevant	ASC 815-10-15-74(a), if the conversion option is indexed to the issuer's stock and classified in stockholders' equity as defined in ASC 815-40 and discussed in Section 5.2.2.1 and Section 5.2.2.2	Put and call options in debt host contracts generally do not qualify for a scope exception.

As demonstrated in this chart, redemption features such as put and call options embedded in debt host contracts typically meet the definition of a derivative and are generally required to be recognized as such if the first and second criteria discussed in Sections 2.3.2 and 2.3.2.1 are also met. Conversion options typically meet the definition of a derivative if net settlement exists, either contractually or because the shares that would be delivered (conversion shares) if the option is exercised are readily convertible to

[4] We believe net settlement would also exist under ASC 815-10-15-107 for conversion features in debt instruments that are in substance redemption options (i.e., the value of the feature is not expected to vary with changes in the fair value of the underlying shares).

cash. Contractual net settlement could result from a provision for the holder to receive the as-converted value in cash. For example, this may exist in the form of a noncontingent put or redemption option that allows the holder to receive the greater of face or the as-converted value in cash.

If contractual net settlement does not exist for a conversion option, consideration should be given to whether the conversion shares are readily convertible to cash. This typically depends on whether the shares are publicly traded and if so, the daily transaction volume.

Are the shares readily convertible to cash?

The determination of whether the shares are readily convertible to cash needs to be considered on an ongoing basis throughout a contract's life. Delisting, an IPO or significant changes in the level of trading activity are examples of factors that could influence the conclusion as consideration needs to be given to whether the smallest increment of shares that would be delivered in accordance with each individual contract is small relative to the daily transaction volume. Assume for example that a debt instrument can be converted at a conversion price that would result in the issuance of 100,000 shares of publicly traded common stock. The average daily trading volume associated with the common stock is 50,000 shares. If the debt instrument could only be converted in total, the 100,000 shares into which it would be converted is large relative to the daily transaction volume, and the common shares would not be considered to be readily convertible to cash. Many instruments permit conversion in whole or in part (i.e., in whatever increment the holder elects), in which case, generally, the common shares would be considered to be readily convertible to cash if they are actively traded. Refer to the guidance beginning at ASC 815-10-15-130 and Example 7 beginning at ASC 815-10-55-99 for additional information.

Given that a conversion option is not clearly and closely related to a debt host contract, if a conclusion is reached that a conversion option is a derivative, consideration would next be given to ASC 815-40 to determine whether it qualifies for an exception to the derivative requirements by being both indexed to the issuer's stock and classified in stockholders' equity. If it does qualify for the exception, reference should be made to Section 2.3.4. If the conversion option is a derivative that does not qualify for this exception, reference should be made to Section 2.3.3. Refer to the guidance at Section 5.2.2.1 and Section 5.2.2.2 in making this determination.

In applying the guidance at Section 5.2.2.2, it is important to first determine whether the instrument is a convertible debt instrument for which the holder may only realize the value of the conversion option by exercising the option and receiving the entire proceeds in a fixed number of shares or, at the issuer's discretion, the equivalent amount of cash, as the guidance in ASC 815-40-25-7 to 25-30 and ASC 815-40-55-2 to 55-6 that requires giving consideration to circumstances that can require net cash settlement is not applicable to conversion options that are embedded in this type of convertible debt. For this purpose, the number of shares is considered fixed even if the conversion rate is subject to standard antidilution adjustments.

Careful attention should be given to circumstances under which the conversion rate may be adjusted, however, as it is not uncommon for convertible instruments to provide for adjustments that extend beyond standard antidilution events, in which case the requirements in ASC 815-40-25-7 to 25-35 and ASC 815-40-55-2 to 55-6 would be applicable. Standard antidilution events are defined to consist of equity restructuring events, such as a stock dividend, stock split, spinoff, rights offering or recapitalization through a large, nonrecurring cash dividend. Adjustments that would be made in the event the issuer issues shares at a price lower than the conversion price are not standard antidilution adjustments.

2.3.2.3 Other potential embedded derivatives within debt host contracts

The following are other potential embedded derivatives within debt host contracts:

- *Default rate of interest.* ASC 815-15-25-46 makes it clear that derivative treatment is not appropriate for interest rates that are reset in the event of default, including violation of a credit-risk related

covenant, a change in the debtor's published credit rating or change in creditworthiness (indicated by a change in its spread over U.S. Treasury bonds, for example). Careful consideration should be given to the default provisions within the agreement as it is not uncommon for the default rate of interest to be triggered in circumstances that are unrelated or not directly related to the creditworthiness of the debtor.

- *Interest based on shares.* Interest payments that are based on share prices or dividends paid on shares (whether shares of the debtor or other entities) may require bifurcation if they are a derivative within the scope of ASC 815 given that these features have characteristics and risks that are associated with an equity host contract rather than a debt host contract.
- *Payments based on sales or other performance measures.* ASC 815-10-15-59 includes a scope exception to derivative recognition that applies to embedded features if the underlying on which settlement is based is specified volumes of sales or service revenues of one of the parties to the contract. While this scope exception does not apply to payments based on changes in sales or revenues due to changes in market prices, it is evident from the example at ASC 815-15-55-10 that in addition to volume of sales or service revenues, the scope exception applies to payments based on a portion of net earnings or operating cash flows. Generally, if contingent payments such as these do not require derivative recognition, they are accounted for in accordance with the guidance in ASC 470-10-25, if relevant, and if not, ASC 450.

2.3.3 Accounting treatment if derivative recognition is required – After adoption of ASU 2020-06

If an embedded feature, such as a conversion or redemption option, requires separate recognition as a derivative asset or liability under ASC 815, it is initially and subsequently measured and carried at fair value, with changes in fair value reflected in earnings in accordance with ASC 815-15-30 and ASC 815-10-35. (Refer to Section 1.4 for a discussion related to the initial recognition and fair value determinations.) The allocation of proceeds to separately recognized derivatives will generally result in the debt carrying amount being less than its face amount, creating a discount that should be amortized using the interest method as elaborated on at Section 2.6.

2.3.4 Accounting treatment if derivative recognition is not required – After adoption of ASU 2020-06

An embedded feature that does not require derivative recognition is not given separate recognition unless required under ASC 470-20. This subtopic is discussed at Section 2.4 and applies to conversion options that are not required to be accounted for as derivatives.

In the event a redemption option is exercised, extinguishment accounting should be applied. Refer to Section 2.5 for further guidance on the accounting upon conversion or extinguishment.

2.3.5 Ongoing need for reassessment of derivative conclusions – After adoption of ASU 2020-06

As pointed out at ASC 815-40-35-8, there is an ongoing need to reassess certain conclusions that were reached related to potential embedded derivatives. For example, reassessment would be necessary if the terms of an instrument are modified. Absent modification of any terms, the primary circumstances necessitating reassessment for debt instruments or debt host contracts relate to conversion options and conclusions reached on whether they meet the definition of a derivative, and if so, whether they qualify for the scope exception in ASC 815-10-15-74(a) by being indexed to the entity's own stock (addressed at Section 5.2.2.1) and meeting the requirements to be classified in equity (addressed at Section 5.2.2.2). Specifically, if derivative treatment hinged on the conclusion reached on whether the conversion shares are readily convertible to cash as discussed at Section 2.3.2.2, as pointed out at ASC 815-10-55-84, this conclusion should be reassessed on an ongoing basis given that this conclusion could change for various reasons, including an IPO, sustained changes in daily trading value and listing or delisting of the shares on a national stock exchange. Increased trading activity could result in a conclusion that a conversion option that was initially not a derivative now is, and vice versa. In reassessing whether or not conversion

options that are deemed to be derivatives qualify for the previously mentioned scope exception, ongoing consideration needs to be given to the requirements for equity classification as summarized at Section 5.2.2.2, unless the instrument is a conventional convertible debt instrument as defined earlier. If, for example, the conclusion changes related to whether an entity can demonstrate it has sufficient authorized shares to settle the conversion option, reclassification may be necessary. Additionally, there may be circumstances that cause the conclusion to change related to whether a feature is considered indexed to the entity's stock as summarized at Section 5.2.2.1. This may be the case, for example, if the conversion terms are subject to adjustment for a limited period of time, because after the terms are no longer subject to adjustment, the conversion feature may be indexed to the entity's stock. It is generally not appropriate to reassess conclusions reached related to the first criterion discussed at Section 2.3.2.1 unless the instrument is subsequently modified.

2.3.5.1 Conversion option subsequently requires derivative recognition

If, upon reassessment, a conversion option that was not previously required to be recognized as a derivative requires derivative recognition, the fair value of that conversion option would be recognized as a liability at its fair value on that date. It would continue to be subsequently measured at fair value with changes in fair value recognized through earnings. ASC 815-40-35-9 indicates that, in these circumstances, the derivative should be separated from the host contract (i.e., the debt carrying amount should be debited in creating the derivative liability), and we believe the discount this creates should be amortized using the interest method over the remaining life of the debt instrument.

2.3.5.2 Conversion option no longer requires derivative recognition

If a conversion option that previously was recognized as a derivative, and upon reassessment no longer should be, ASC 815-15-35-4 indicates that the carrying amount of the conversion option (fair value on the reclassification date) should be reclassified from a liability to shareholders' equity without subsequent adjustment to fair value. The debt discount that was created when the conversion option was originally recognized as a derivative should continue to be amortized. In the event the holder elects to exercise the conversion option, any remaining unamortized discount should be recognized as interest expense upon conversion in accordance with ASC 815-15-40-1. If the instrument is extinguished before its stated maturity date rather than converted, the reacquisition price needs to be allocated to both the equity and debt components of the instrument to determine the gain or loss on extinguishment. Namely, a portion of the reacquisition price equal to the fair value of the conversion option at the date of the extinguishment is allocated to equity with the remainder allocated to the extinguishment of the debt in accordance with ASC 815-15-40-4.

2.4 ASC 470-20 considerations when the debt instrument is convertible – After adoption of ASU 2020-06

If a conversion option embedded in a convertible instrument does not require separate recognition as a derivative, the guidance in ASC 470-20 should be considered. If convertible debt is issued at a substantial premium, it is generally appropriate to recognize the premium in its entirety as additional paid-in capital as discussed at Section 2.4.1. Section 2.5 addresses the accounting for a convertible debt instrument when no separate recognition is warranted for the conversion option, as well as the guidance upon conversion under various scenarios.

2.4.1 Convertible debt instruments issued at a substantial premium – After adoption of ASU 2020-06

ASC 470-20-25-13 provides that, if a convertible debt instrument is issued at a substantial premium, there is a presumption that the premium represents additional paid-in capital. We believe this should be considered only after determining that derivative recognition is not necessary for the conversion option. The intent of ASC 470-20-25-13 is somewhat of a catch all in that if, after considering the other guidance, you are left with a convertible instrument that is issued at an initial carrying amount that is significantly

greater than its face, that premium should be recognized in its entirety as additional paid-in capital. A circumstance we have observed in practice relates to modifications of convertible instruments that result in extinguishment accounting under ASC 470-50, whereby the modified debt instruments are required to be measured at fair value. As a result of the conversion feature being in the money at the fair value measurement date, the instruments had a fair value that was significantly in excess of the face amount. An example follows.

Example: Convertible debt issued at a substantial premium

A convertible debt instrument with a face amount of $10 million is recorded at its fair value on June 15, 20XX as a result of a debt extinguishment. The fair value of the debt is determined in accordance with ASC 820 and estimated to be $15 million, a premium of $5 million or 50 percent. This premium is primarily attributable to the fact that the conversion feature is significantly in the money at the valuation date given that the value of the shares into which the instrument can be converted was $13 million at that time. Given that the premium is substantial and attributable in part to the conversion feature being in the money, we believe it would be appropriate to record the full $5 million premium as additional paid-in capital.

Substantial premium is not defined; however, in practice, some have referred to ASC 470-50-40-10, which uses a threshold of 10 percent or more change in the present value of cash flows in determining whether a modified instrument is substantially different. Applying this guidance by analogy, a premium of 10 percent or more (measured after allocation of proceeds to other instruments if warranted) would be considered to be substantial. We have observed instances whereby without the recognition of the premium as additional paid-in capital, the accretion of the premium would more than offset the contractual interest expense, resulting in negative interest expense recognition on the debt instrument. Circumstances such as this may warrant recognition of the premium as additional paid-in capital regardless of the percentage size of the premium.

The SEC staff guidance in ASC 480-10-S99-3A also should be considered to determine whether a substantial premium recognized in equity in accordance with ASC 470-20 should be classified as temporary equity. This would be the case if, as of the balance sheet date, the issuer can be required to settle the convertible instrument for cash or other assets (i.e., the instrument is currently redeemable or convertible for cash or other assets). The portion of the equity-classified component that is presented in temporary equity (if any) is measured as the excess of the amount of cash or other assets that would be required to be paid to the holder upon redemption or conversion over the current carrying amount of the liability-classified component of the convertible debt instrument. For example, if the convertible debt instrument is currently redeemable at the option of the holder for $1,000 in cash, and the liability-classified component of the instrument has a carrying amount of $950, $50 of the equity-classified component should be presented as temporary equity.

2.4.2 Interest Forfeiture – After adoption of ASU 2020-06

If the terms of a convertible debt instrument provide that any accrued but unpaid interest at the date of conversion is forfeited, that interest should be accrued or imputed to the date of conversion in accordance with ASC 470-20-35-11.

2.5 Derecognition – After adoption of ASU 2020-06

The guidance in this section addresses derecognition of a convertible debt instrument in the following situations:

- Conversion pursuant to the debt instrument's contractual terms when the conversion option was not separately accounted for as a derivative (Section 2.5.1).

- Conversion, modification or extinguishment of the debt instrument for which a conversion option was recognized as a derivative (Section 2.5.2).
- Conversion pursuant to an induced conversion (Section 2.5.3).
- Conversion due to the issuer's exercise of a call option (Section 2.5.4).
- Conversion not pursuant to contractual terms. (Section 2.5.5).
- Modifications or extinguishments of a convertible debt instrument (Section 2.5.6).

2.5.1 Conversion pursuant to the contractual terms when conversion option was not separately accounted for as a derivative – After adoption of ASU 2020-06

If the determination was made that no separate recognition was necessary for the conversion feature, when the convertible debt is converted to shares pursuant to the original conversion terms, the carrying amount of the debt inclusive of any accrued interest that is contractually converted as well as unamortized discounts, premiums or issuance costs is removed through a credit to the respective capital accounts for the shares, with no gain or loss recognized. If, in addition to shares, cash or other assets were transferred as part of this contractual conversion, the carrying amount of the converted debt first would be reduced by the amount of cash or other assets transferred in accordance with ASC 470-20-40-4 before reclassifying the remaining carrying amount of the debt to the capital accounts. If interest that is not paid upon conversion (see the discussion regarding interest forfeiture in Section 2.4.2) is not deductible for income tax purposes, any related tax benefit that may have been recognized previously should be charged to additional paid-in capital.

We believe that when conversion is pursuant to a share-settled redemption feature rather than a standard conversion option (see related discussion in Section 2.3.1), the conversion should be accounted for as a debt extinguishment as discussed in Section 2.5.5.

2.5.2 Conversion, modification or extinguishment of the debt instrument for which a conversion option was recognized as a derivative – After adoption of ASU 2020-06

2.5.2.1 Conversion

In those circumstances where the conversion feature was required to be bifurcated and accounted for as a derivative liability at fair value, there is no equity conversion feature remaining in the debt instrument for accounting purposes. Therefore, while there may be a legal conversion of the debt, for accounting purposes both the debt host contract and the bifurcated conversion feature are subject to extinguishment accounting because these liabilities are being satisfied in exchange for shares. As such, in general, a gain or loss upon extinguishment equal to the difference between the recorded value of the liabilities and the fair value of the shares issued to extinguish them should be recorded.

Accounting for the conversion of convertible debt when the conversion feature was separately recognized as a derivative liability requires the following three steps:

1. Update the valuation of the conversion feature and any other bifurcated derivatives to the legal conversion date through earnings as necessary. (Note that if conversion occurred on the expiration date of the conversion feature, the fair value likely would be the intrinsic value on that date. Otherwise, an option pricing model that gives consideration to the remaining exercise period generally would be used to estimate the fair value. We have observed diversity in practice in that some entities adjust the conversion feature to intrinsic value rather than fair value at the conversion date. The impact to the income statement in total should be the same as the impact of adjusting the carrying value of the feature to intrinsic value rather than fair value, given that the gain or loss on extinguishment will change accordingly.)

2. Adjust the carrying value of the host debt instrument through interest expense if necessary to bring the amortization or accretion of any premiums, discounts or unamortized issuance costs up to date as of conversion.
3. Recognize the difference between the fair value of the shares that are issued in satisfaction of the debt and the updated net carrying amount of the debt (with consideration given to any remaining unamortized premiums, discounts and issuance costs) and conversion feature as an extinguishment gain or loss.

The following example illustrates the entries under the two alternatives discussed in Step 1.

Example: Accounting for the conversion of debt for which the conversion option was recognized as a derivative

Assume that debt with a face amount of $10,000 and a maturity date in 20X5 was converted in full on December 31, 20X4. The fair value of the conversion feature estimated using an option pricing model decreased by $100 since the most recent valuation date to $500 as of the conversion date. The intrinsic value of the conversion feature as of the conversion date was $400 determined as the excess of the value of the common shares at that date over the conversion price. A discount on the debt was created through the recognition of the conversion feature as a derivative at the issuance date. Assume that on the conversion date, the net carrying amount of the debt after the accretion of the issuance-date discount to the conversion date was $9,500.

	Adjust conversion feature to fair value		Adjust conversion feature to intrinsic value	
	Debit	Credit	Debit	Credit
Adjust carrying amount of derivative to conversion date value				
Derivative liability	$100		$200	
Other income		$100		$200
Record common stock at fair value and remove debt and related derivative				
Debt	$9,500		$9,500	
Derivative liability	500		400	
Loss on extinguishment	400		500	
Common stock (par and additional paid-in capital)		$10,400		$10,400
Net impact to income statement	**$300**		**$300**	

2.5.2.2 Modification or extinguishment

For a discussion of modification and extinguishment considerations related to convertible debt instruments in general, refer to Section 2.5.6 of this guide, as well as our debt modifications and restructurings guide. As is noted in ASC 470-50-40-11, the guidance in ASC 470-50-40-10 specific to conversion options does not pertain to convertible instruments for which the conversion option is separately accounted for as a derivative. As such, there is no guidance that specifically addresses the accounting for the modification of such an instrument. Given that the conversion option is separated from the debt, we believe the cash flows test in ASC 470-50-40-10 should be applied to the debt instrument ignoring the conversion feature, particularly in those circumstances in which the conversion option requires separate recognition as a derivative both before and after the modification. Any changes in the fair value of the conversion option that are associated with a modification will be recognized in earnings as the carrying amount of the conversion option is adjusted to its fair value post modification. The

extinguishment of a convertible debt instrument for which the conversion option is separately accounted for as a derivative is addressed in the example in Section 2.5.2.1.

2.5.3 Induced conversion – After adoption of ASU 2020-06

Issuers may for various reasons decide to induce conversion of a convertible debt instrument by offering certain incentives to make conversion more attractive. An induced conversion, as defined and discussed in ASC 470-20-40-13 to 40-17, involves a situation whereby the conversion privileges in a convertible debt instrument are changed, or additional consideration is paid, to debt holders for the purpose of inducing prompt conversion of the debt to equity securities. To be an induced conversion, the conversion must both:

a. Occur pursuant to changed conversion privileges that are exercisable only for a limited period of time
b. Include the issuance of all of the equity securities issuable pursuant to conversion privileges included in the terms of the debt at issuance, regardless of the party that initiates the offer or whether the offer relates to all debt holders

The changed terms may involve the reduction of the original conversion price so that additional shares of stock are issued, the issuance of warrants or other securities not provided for in the original conversion terms, or the payment of cash or other consideration to those debt holders who convert during the specified limited period of time.

When both conditions specified in the preceding paragraph are met, the issuer should recognize an expense equal to the fair value of all securities and other consideration transferred in the transaction in excess of the fair value of securities issuable pursuant to the original conversion terms. The fair value of the securities and any other consideration should be measured as of the date the inducement offer is accepted. (This is normally the date the debt holder converts or enters into a binding agreement to convert.)

The following example from ASC 470-20-55-3 to 55-5 illustrates this accounting. For simplicity, the face amount of each security is assumed to be equal to its carrying amount in the financial statements (that is, no original issue premium or discount exists).

> On January 1, 19X4, Entity A issues a $1,000 face amount 10 percent convertible bond maturing December 31, 20X3. The carrying amount of the bond in the financial statements of Entity A is $1,000, and it is convertible into common shares of Entity A at a conversion price of $25 per share. On January 1, 19X6, the convertible bond has a fair value of $1,700. To induce convertible bondholders to convert their bonds promptly, Entity A reduces the conversion price to $20 for bondholders that convert before February 29, 19X6 (within 60 days).
>
> Assuming the market price of Entity A's common stock on the date of conversion is $40 per share, the fair value of the incremental consideration paid by Entity A upon conversion is calculated as follows for each $1,000 bond that is converted before February 29, 19X6.

Value of securities issued (a)	$2,000
Value of securities issuable pursuant to original conversion privileges (b)	1,600
Fair value of incremental consideration	$400

(a) Value of securities issued to debt holders is computed as follows:

Face amount	$1,000	
÷ New conversion price	÷ $20	per share
Number of common shares issued upon conversion	50	shares
× Price per common share	× $40	per share
Value of securities issued	$2,000	

(b) Value of securities issuable pursuant to original conversion privileges is computed as follows:

Face amount	$1,000	
÷ Original conversion price	÷ $25	per share
Number of common shares issuable pursuant to original conversion privileges	40	shares
× Price per common share	× $40	per share
Value of securities issuable pursuant to original conversion privileges	$1,600	

Therefore, Entity A records debt conversion expense equal to the fair value of the incremental consideration paid as follows.

	Debit	Credit
Convertible debt	$1,000	
Debt conversion expense	400	
Common stock		$1,400

2.5.4 Conversion due to the issuer's exercise of a call option – After adoption of ASU 2020-06

If an instrument becomes convertible due to the issuer's exercise of a call option and the conversion option is considered to be nonsubstantive as of the instrument's issuance date, the conversion would be accounted for as a debt extinguishment. If the conversion feature is deemed to be substantive as of its issuance date, the conversion is accounted for as a conversion; that is, there is no gain or loss recognized related to the equity securities issued to settle the instrument. By definition, a substantive conversion feature is at least reasonably possible of being exercised in the future. Instruments with extremely high conversion prices at the issuance date or that only become convertible if the issuer exercises a call option are generally considered to have conversion features that are not substantive. ASC 470-20-40-9 provides additional guidance to be used in making this determination.

2.5.5 Conversion not pursuant to contractual terms – After adoption of ASU 2020-06

ASC 470-50-15 does not apply to conversions that occur in accordance with the contractual terms or to induced conversions; however, it does apply to extinguishments effected by issuing stock that does not represent the exercise of a substantive conversion right contained in the terms of the debt at issuance. For example, if debt is converted into the issuer's shares pursuant to either a share-settled redemption feature or terms not contractually provided for in the note, the conversion is accounted for as a debt extinguishment under ASC 470-50. This assumes the conversion is not an induced conversion or a troubled debt restructuring. Under extinguishment accounting, the difference between the fair value of the shares that are issued in satisfaction of the debt and the net carrying amount of the debt (with consideration given to any remaining unamortized premiums, discounts and issuance costs) is recognized as an extinguishment gain or loss. However, to the extent the borrower and lender are related entities, consideration should be given to whether the extinguishment of a loan is effectively a capital transaction between the parties. For additional guidance on the accounting for an extinguishment, refer also to our debt modifications and restructurings guide.

2.5.6 Modifications or extinguishments – After adoption of ASU 2020-06

ASC 470-50 includes guidance specific to convertible debt in the context of modifications and extinguishments. As pointed out in ASC 470-50-15, this guidance does not apply to conversions that occur in accordance with the contractual terms or to induced conversions; however, it does apply to modifications of convertible debt and to extinguishments effected by issuing stock that does not represent the exercise of a conversion right contained in the terms of the debt at issuance. Excerpts are as follows:

- ASC 470-50-40-5 indicates that if debt issued with warrants is permitted to be tendered towards the exercise price of the warrants, any such tendering would be accounted for in the same manner as a conversion rather than an extinguishment.
- ASC 470-50-40-10 to 40-12 include guidance on determining how modifications to an embedded conversion option, or the addition or elimination of a conversion option, should be considered in determining if a modified debt instrument is substantially different.
- ASC 470-50-40-14 and 40-15 address how a change in the fair value of a conversion option should be accounted for if a modification occurs.

The guidance in Section 2.5.2.2 addresses modifications and extinguishments when the conversion feature was given separate recognition as a derivative. For additional guidance, refer also to our debt modifications and restructurings guide.

2.6 Amortizing discounts on debt or redeemable preferred stock – After adoption of ASU 2020-06

ASC 835-30 requires the use of the interest method, which is defined as "the method used to arrive at a periodic interest cost (including amortization) that will represent a level effective rate on the sum of the face amount of the debt and (plus or minus) the unamortized premium or discount and expense at the beginning of each period." The use of a straight-line or other simplified approach for amortizing discounts can significantly distort the results, particularly when, as a result of allocating proceeds to other instruments, the initial carrying amount of the debt or redeemable stock is significantly less than the face amount. Here is an example illustrating this in the context of a non-amortizing debt instrument with a face amount of $5 million. The initial net carrying amount of the debt is $2 million, given that proceeds of $3 million were allocated to warrants, creating a discount on the debt. As is illustrated through this example on the next two pages, the use of the straight-line method rather than the interest method results in an overstatement of interest expense of $454,898 in the first year that reverses in the second year. The computation would be similar for redeemable stock; however, dividends (rather than interest expense) would be recognized if the redeemable stock is accounted for as equity or temporary equity.

Date	A Principal	B (Note 1) Unamortized discount	C = A – B Net carrying amount	D (Note 2) Contractual interest (10%)	Interest method E = F – D Amortization	Interest method F (Note 3) Total interest
1/1/2014	$5,000,000	($3,000,000)	$2,000,000			
1/31/2014	5,000,000	(2,936,193)	2,063,807	$41,096	$63,807	$104,903
2/28/2014	5,000,000	(2,873,516)	2,126,484	38,356	62,677	101,033
3/31/2014	5,000,000	(2,800,727)	2,199,273	42,466	72,789	115,255
4/30/2014	5,000,000	(2,726,468)	2,273,532	41,096	74,259	115,355
5/31/2014	5,000,000	(2,645,709)	2,354,291	42,466	80,759	123,225
6/30/2014	5,000,000	(2,563,319)	2,436,681	41,096	82,390	123,486
7/31/2014	5,000,000	(2,473,717)	2,526,283	42,466	89,602	132,068
8/31/2014	5,000,000	(2,379,259)	2,620,741	42,466	94,458	136,924
9/30/2014	5,000,000	(2,282,893)	2,717,107	41,096	96,366	137,462
10/31/2014	5,000,000	(2,178,092)	2,821,908	42,466	104,801	147,267
11/30/2014	5,000,000	(2,071,175)	2,928,825	41,096	106,917	148,013
12/31/2014	5,000,000	(1,954,899)	3,045,101	42,466	116,276	158,742
Subtotal						1,543,733
1/31/2015	5,000,000	(1,832,321)	3,167,679	42,466	122,578	165,044
2/28/2015	5,000,000	(1,715,604)	3,284,396	38,356	116,717	155,073
3/31/2015	5,000,000	(1,580,056)	3,419,944	42,466	135,548	178,014
4/30/2015	5,000,000	(1,441,771)	3,558,229	41,096	138,285	179,381
5/31/2015	5,000,000	(1,291,381)	3,708,619	42,466	150,390	192,856
6/30/2015	5,000,000	(1,137,954)	3,862,046	41,096	153,427	194,523
7/31/2015	5,000,000	(971,098)	4,028,902	42,466	166,856	209,322
8/31/2015	5,000,000	(795,198)	4,204,802	42,466	175,900	218,366
9/30/2015	5,000,000	(615,746)	4,384,254	41,096	179,452	220,548
10/31/2015	5,000,000	(420,586)	4,579,414	42,466	195,160	237,626
11/30/2015	5,000,000	(221,485)	4,778,515	41,096	199,101	240,197
12/31/2015	-	-	-	42,466	221,485	263,951
Subtotal						2,454,901
Total				$998,634	$3,000,000	$3,998,634

Note 1: Unamortized discount is computed by reducing the previous month's unamortized discount balance by the current month's amortization.

Note 2: Contractual interest is computed by multiplying the outstanding principal balance at the beginning of the month by 10 percent, dividing that result by 365 days and multiplying that result by the number of days in the month for which interest is payable.

Note 3: Total interest is computed by multiplying the net carrying amount at the beginning of the month by the effective interest rate (63.816 percent), dividing that result by 365 days and multiplying that result by the number of days in the month. (The effective interest rate was determined by solving for the rate that equates the present value of the future cash outflows to the initial net carrying amount of $2 million.) In addition, total interest for December 2015 includes an additional $4,956 for balancing purposes due to rounding.

Date	Principal	A (Note 1)	Straight-line method		Interest method	Difference
			B (Note 2)	A + B		
		Contractual interest (10%)	Amortization	Total interest	Total interest	
1/1/2014	$5,000,000					
1/31/2014	5,000,000	$41,096	$127,397	$168,493		
2/28/2014	5,000,000	38,356	115,068	153,424		
3/31/2014	5,000,000	42,466	127,397	169,863		
4/30/2014	5,000,000	41,096	123,288	164,384		
5/31/2014	5,000,000	42,466	127,397	169,863		
6/30/2014	5,000,000	41,096	123,288	164,384		
7/31/2014	5,000,000	42,466	127,397	169,863		
8/31/2014	5,000,000	42,466	127,397	169,863		
9/30/2014	5,000,000	41,096	123,288	164,384		
10/31/2014	5,000,000	42,466	127,397	169,863		
11/30/2014	5,000,000	41,096	123,288	164,384		
12/31/2014	5,000,000	42,466	127,397	169,863		
Subtotal				1,998,631	$1,543,733	$454,898
1/31/2015	5,000,000	42,466	127,397	169,863		
2/28/2015	5,000,000	38,356	115,068	153,424		
3/31/2015	5,000,000	42,466	127,397	169,863		
4/30/2015	5,000,000	41,096	123,288	164,384		
5/31/2015	5,000,000	42,466	127,397	169,863		
6/30/2015	5,000,000	41,096	123,288	164,384		
7/31/2015	5,000,000	42,466	127,397	169,863		
8/31/2015	5,000,000	42,466	127,397	169,863		
9/30/2015	5,000,000	41,096	123,288	164,384		
10/31/2015	5,000,000	42,466	127,397	169,863		
11/30/2015	5,000,000	41,096	123,289	164,385		
12/31/2015	-	42,466	127,398	169,864		
Subtotal				2,000,003	2,454,901	(454,898)
Total		$998,634	$3,000,000	$3,998,634	$3,998,634	$ -

Note 1: Contractual interest is computed by multiplying the outstanding principal balance at the beginning of the month by 10 percent, dividing that result by 365 days and multiplying that result by the number of days in the month for which is interest is payable.

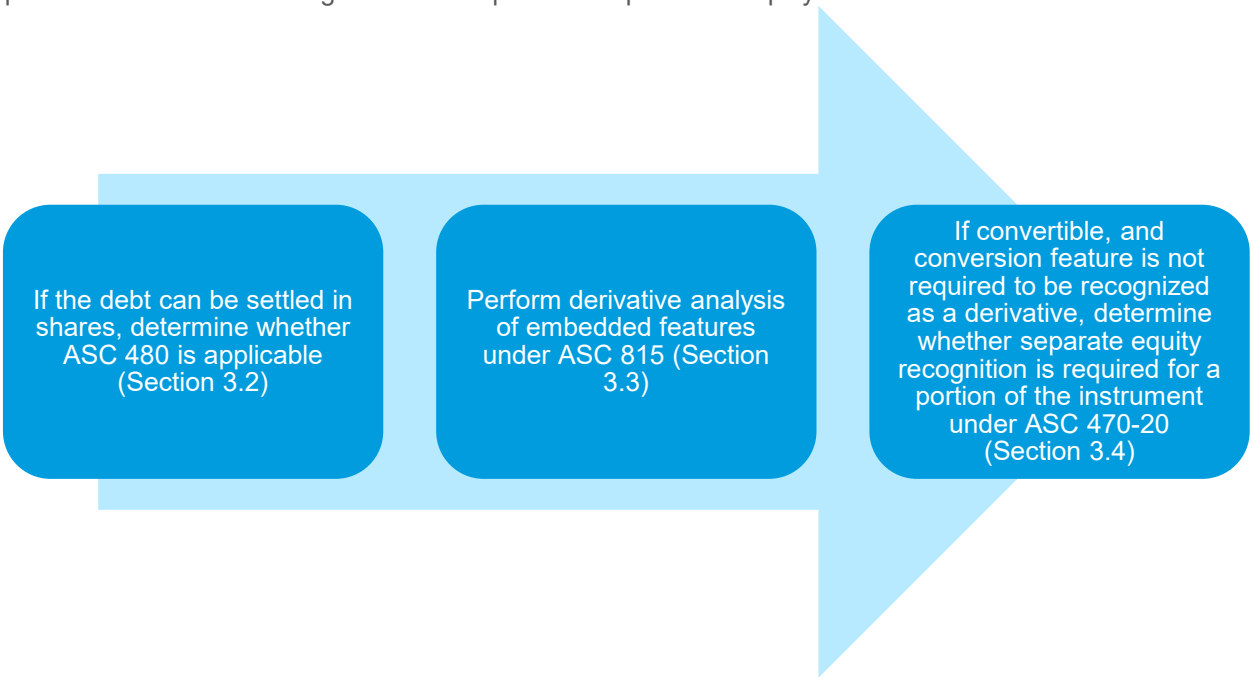
Note 2: Amortization is computed by dividing the total discount of $3 million by the number of days in the term of the debt (730) and multiplying that result by the number of days in the month.

Chapter 3: Accounting for debt with conversion options and other embedded features – Before adoption of ASU 2020-06

3.1 Introduction

This chapter assumes ASU 2020-06 has not been adopted. Chapter 2 addresses the accounting for debt with conversion options subsequent to the adoption of ASU 2020-06. Refer to Appendix C for additional information on ASU 2020-06.

The accounting for debt with conversion options and other embedded features, such as put and call options, necessitates giving consideration to (a) ASC 480 to determine whether the debt is within its scope, (b) ASC 815 to determine whether any of the features embedded in the debt agreement need to be separately recognized as a derivative, and (c) ASC 470-20 for convertible debt for which the conversion feature does not require derivative accounting to determine whether a portion of the debt proceeds needs to be recognized as a separate component of equity.



Sections 3.2 through 3.4 summarize the accounting analysis necessary to make these determinations and the resulting ramifications. Additionally, Section 3.5 of this chapter contains an illustration of interest expense recognition, including discount amortization, using the interest method. For guidance related to debt modifications and restructurings, refer to our debt modifications and restructurings guide. Lastly, refer to the exhibit at the end of this chapter for a high-level overview of the accounting for a convertible instrument when (a) the conversion feature is required to be separately recognized as either (i) a derivative in accordance with ASC 815, (ii) a cash conversion feature in accordance with ASC 470-20 or (iii) a beneficial conversion feature in accordance with ASC 470-20 and (b) the conversion feature is not required to be separately recognized.

3.2 ASC 480 considerations – Before adoption of ASU 2020-06

While a debt instrument should be classified as a liability regardless of whether ASC 480 applies, if a debt instrument may be settled in shares, consideration should be given to ASC 480-10-25-14 because, if applicable, this could impact the measurement of the instrument and the relevant disclosure requirements. Specifically, a debt instrument that embodies a conditional or unconditional obligation that the issuer must or may settle by issuing a variable number of its equity shares would be subject to ASC

480 if, at inception, the monetary value of the obligation is based solely or predominantly on any one of the following criteria (referred to for the remainder of this section as *the three criteria*):

1. A fixed monetary amount known at inception (e.g., a payable settled with the number of issuer's equity shares required to equate to a fixed amount of value)
2. Variations in something other than the fair value of the issuer's equity shares (e.g., a financial instrument indexed to the Standard & Poor's 500 index and settled with a variable number of the issuer's equity shares)
3. Variations inversely related to changes in the fair value of the issuer's equity shares (e.g., a written put option that could be net share settled)

Understanding the terminology

The following are key terms used in ASC 480-10, along with their definitions from the Master Glossary of the ASC:

- **Monetary value**: "What the fair value of the cash, shares, or other instruments that a financial instrument obligates the issuer to convey to the holder would be at the settlement date under specified market conditions."
- **Obligation**: "A conditional or unconditional duty or responsibility to transfer assets or to issue equity shares."

Generally, instruments that are convertible to shares at the holder's option are not subject to ASC 480. However, a debt instrument that must or may be settled in a variable number of the issuer's equity shares (through conversion or otherwise) may be subject to ASC 480 if it meets any of the three criteria. An example of an instrument that may meet the first criterion is a debt instrument that will be settled in a variable number of shares, with that number to be determined based on 80 percent of the conversion date fair value of a share (i.e., a 20 percent discount). In this case, the holder receives the same value regardless of the share price at the time of the conversion. For example, if the face amount of the debt was $1 million and the share price was $6 at the time of conversion, the holder would receive 208,333 shares ($1 million face amount divided by 80 percent of the $6 share price) worth $6 each for an extended value of $1.25 million. If the share price was $7 at the time of conversion, the holder would receive 178,571 shares ($1 million face amount divided by 80 percent of the $7 share price) worth $7 each for the same extended value of $1.25 million.[5]

An instrument that meets the first criterion generally would be accounted for as stock-settled debt (which, in the preceding example, entails accreting the carrying amount up to the $1.25 million settlement amount through the settlement date in accordance with the interest method illustrated in Section 3.5) if the monetary value of the obligation is based solely or predominantly on a fixed settlement amount. Other instruments that fall within the scope of ASC 480 by meeting the second or third criterion may necessitate subsequent measurement at fair value under ASC 480-10-35-5 unless another subtopic of U.S. GAAP specifies a different measurement attribute.

The analysis of whether a debt instrument is within the scope of ASC 480 becomes more complex when the monetary value is in part, but not solely, based on one of the three criteria. Subjectivity comes into

[5] As noted in the footnote to the section that follows, some bridge notes are settled in a variable number of shares upon the occurrence of a qualified financing event, with the number of shares determined based on the price at which shares are issued in the financing event. These instruments generally are not viewed as being subject to ASC 480-10-25-14 unless an obligation exists at the issuance date to conduct a qualified financing event, and settlement in a manner that meets the first criterion is deemed to be predominant at the issuance date.

play in determining whether the monetary value is based predominantly on one of these criteria as *predominantly* is not defined in ASC 480. We are aware of divergent views in practice as to whether *predominant* should be interpreted as more likely than not or a higher threshold, such as 90 percent as suggested by the use of the words "in small part" in ASC 480-10-55-22. Other examples in ASC 480-10-55 also may be useful in making this determination. In the context of the example in the preceding paragraph, if the number of shares to be issued is determined based on an average share fair value over a stated period of time (e.g., 30 days before settlement) rather than the fair value of the shares on the conversion date, based on the example in ASC 480-10-55-22, a conclusion would be reached that while the monetary value is in small part based on variations in the fair value of the shares that can occur during the 30 day period, the monetary value is predominantly fixed such that the first criterion would be met.

In circumstances involving multiple potential settlement outcomes, the analysis becomes even more complex as it is necessary to assess as of the issuance date which outcome is predominant. In the preceding example, the debt will settle in shares at a discount to the conversion date fair value (a situation that may meet the first of the three criteria). If the debt in that example was also convertible at the holder's option into a fixed number of shares or could be settled in cash upon its maturity (two alternatives that would not meet any of the three criteria), the reporting entity would need to determine whether an outcome that meets one of the criteria is predominant. In making this determination, consideration should be given to all pertinent information, such as the current stock price and volatility, the strike price of the instrument and any other relevant factors to determine whether, for example, it would be more advantageous for the holder to elect to convert to the fixed number of shares. If settlement in a manner that meets one of the three criteria is determined to be predominant, the instrument is accounted for in accordance with ASC 480. If not, the feature that could result in the issuance of a variable number of shares is evaluated to determine whether it should be separately recognized as a derivative as discussed in the next section.

3.3 Derivative analysis of embedded features – Before adoption of ASU 2020-06

3.3.1 Overview

It is common for debt instruments to have embedded features that may require separate recognition as derivatives, including conversion options, early redemption features (such as put and call options), additional payments if a contingent event such as a change in control occurs, and interest that is indexed to something other than interest rates. While the focus of this section is on the features we have most commonly observed in practice, there may be other features within a debt instrument that necessitate similar consideration of the guidance that follows. The focus should be on features that can alter the amount or timing of cash flows or the value of other exchanges (e.g., conversion shares).

Distinguishing between conversion and redemption options

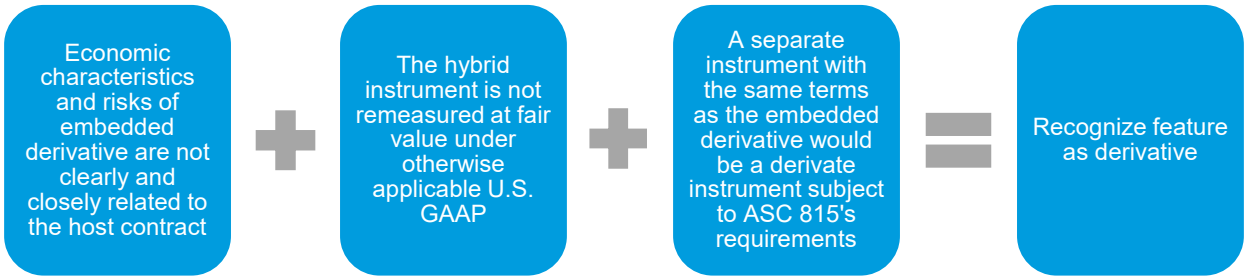
Standard conversion options allow for conversion of the debt into a fixed or substantially fixed number of shares. Standard redemption features, such as put and call options, give the holder the right to put the debt to the issuer (or the issuer the right to call the debt from the holder) at a stated amount to be paid in cash or shares. Some instruments provide for conversion into a variable number of shares, with the number of shares determined at the time of conversion based on the fair value of the shares at the conversion date. Such a feature is designed to ensure that the holder receives a predetermined amount of value paid in whatever number of shares it takes to arrive at that value.[6] In other words, the

[6] We have observed several variations of debt instruments in practice (typically bridge financing notes) that contractually convert into the class of shares issued in the next qualified financing event (as defined in the agreement) at the price at which shares are issued in the financing event, or a percentage of that price (e.g., 80% of

value that the holder is expected to receive upon conversion is not expected to vary based on changes in the value of the underlying shares. Assuming that this feature does not result in classification as stock-settled debt as discussed at Section 3.2, we believe it would be appropriate to analyze this feature as a redemption option rather than a conversion option in the analysis that follows to determine when certain embedded features must be separately recognized as derivatives.

The determination of which, if any, embedded features must be separately recognized as derivatives is complex. Specifically, ASC 815-15-25-1 requires derivative recognition for embedded features if all of the following three criteria are met:

1. The economic characteristics and risks of the embedded derivative are not clearly and closely related to the economic characteristics and risks of the host contract.
2. The hybrid instrument is not remeasured at fair value under otherwise applicable U.S. GAAP.
3. A separate instrument with the same terms as the embedded derivative would be a derivative instrument subject to the requirements of ASC 815 (i.e., it meets the definition of a derivative and does not qualify for one of the scope exceptions outlined in ASC 815-10-15-13).



3.3.2 Application of the embedded derivatives guidance to common features in debt instruments – Before adoption of ASU 2020-06

Criteria 1 and 3 above are discussed in more depth in the sections that follow. Regarding Criterion 2, if the debt instrument qualifies, and the reporting entity elects to account for it at fair value or the instrument is required to be accounted for at fair value on an ongoing basis, no embedded derivatives would require separate recognition, and the embedded derivative analysis is not relevant.

3.3.2.1 Criterion 1

The first criterion to consider in the embedded derivative analysis is whether the economic characteristics and risks of the embedded derivative are clearly and closely related to the economic characteristics and risks of the host contract. Instruments issued in financing transactions are analyzed to determine whether the host contract is more debt-like or equity-like. This analysis is based on all stated and implied substantive terms and features, with each term and feature evaluated and weighted to determine whether a specific instrument is more debt-like or equity-like.

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the qualified financing price). Generally, such features are evaluated as a redemption option rather than a conversion option, assuming that the qualified financing event is defined in a manner that one would expect the shares to be issued at a price reflective of fair value, such that the feature is designed to give the debt holders a fixed amount of value paid in a variable number of shares. (That may not be the case if the financing event is defined to be substantially based on the exercise or conversion of preexisting warrants or convertible instruments at preestablished contractual strike prices). In some cases, there may be multiple conversion features or optionality in the conversion price (i.e., the debt will convert at the lower of a predefined price or a predefined percentage of the qualified financing price), in which case, the instrument may contain both a conversion option and a redemption option.

Instruments issued in the legal form of debt, as well as certain preferred or other stock that have strong debt-like characteristics, generally are considered to have a debt host contract. (Refer to Section 4.3.2.1 for the determination of the nature of the host contract for preferred stock and similar instruments issued in the form of a share.) The primary economic characteristics and risks associated with a debt host are interest rates, inflation and credit risk.

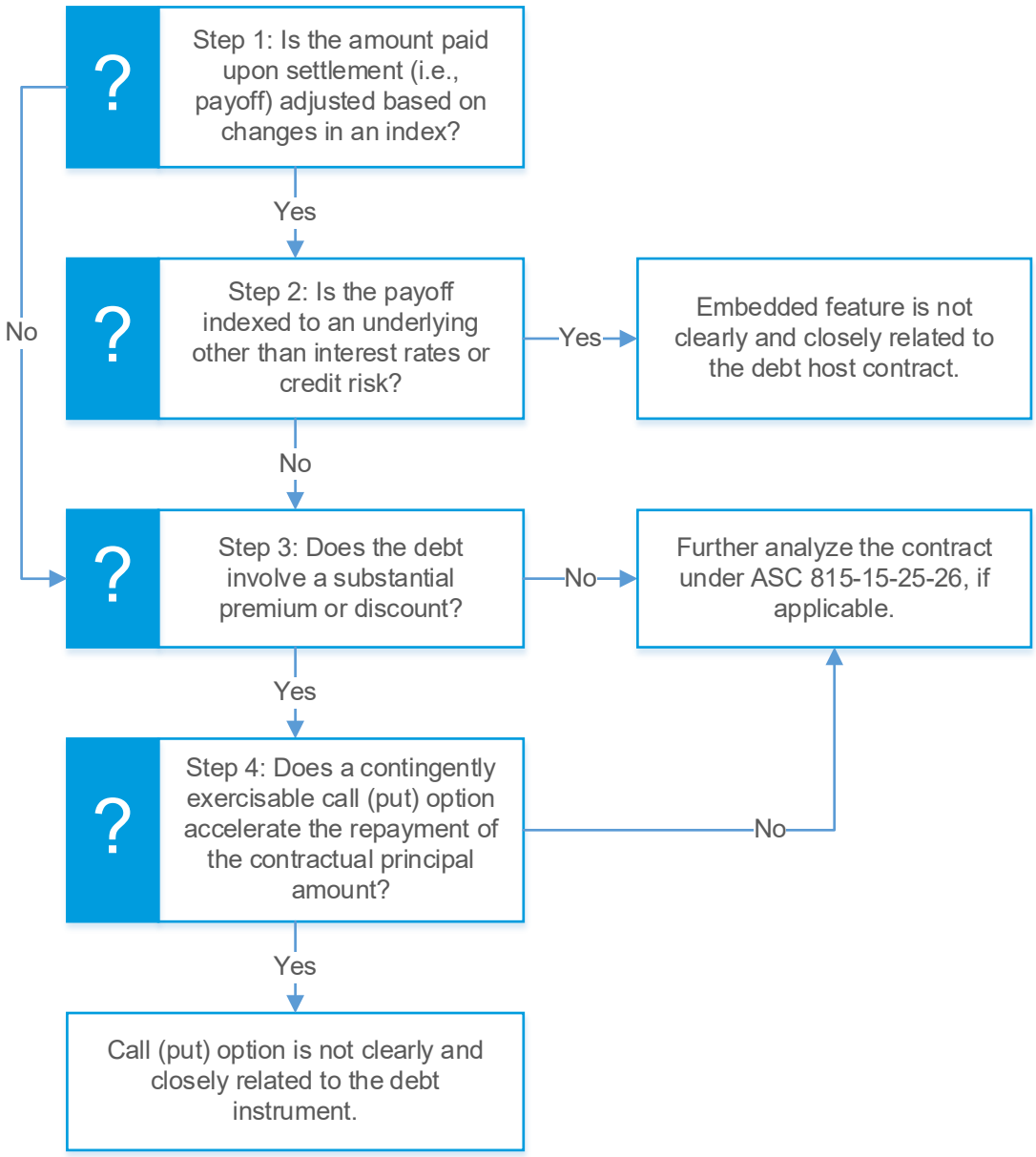
As pointed out in ASC 815-15-25-51, equity conversion options are not clearly and closely related to a debt host contract because their underlying value is dependent upon the value of an equity interest. As it relates to redemption features within debt instruments that can accelerate repayment (whether in cash or shares), such as put and call options, additional analysis is necessary to determine whether a particular feature is clearly and closely related to the debt host contract. Specific guidance relevant to this determination is primarily found in ASC 815-15-25-26 and ASC 815-15-25-42.

The guidance in ASC 815-15-25-26 does not apply if there is an underlying related to the put or call option other than interest rates or an interest rate index. If, for example, a put or call option only can be exercised upon the occurrence of a contingent event, which is another underlying, this guidance is not relevant.

The guidance on put and call options in ASC 815-15-25-42 outlines a four-step decision sequence that should be followed in determining whether options that can accelerate the settlement of debt instruments are clearly and closely related to the debt host contract. This decision sequence results in a conclusion that put and call options are not clearly and closely related under any of the following circumstances:

- Rather than being the repayment of principal at par, the payoff amount is indexed to something other than interest rates or credit risk.
- The debt involves a substantial premium or discount, and the option is contingently exercisable.
- One of the two conditions from ASC 815-15-25-26 (outlined later in this section) are met, if applicable.

The four-step decision sequence in ASC 815-15-25-42 follows on the next page.



An example of the type of put or call option we have observed most frequently in practice that is not clearly and closely related to the debt host contract is a feature that will result in payment of the debt at a significant premium upon the occurrence of a contingent event, such as a change in control. When considering Steps 1 and 2 of the decision sequence, we believe repayments that are based on either a fixed premium to par or a premium that changes due to the passage of time would not be considered indexed to something other than interest rates or credit risk. In evaluating the significance of a premium or discount in Step 3, in practice, premiums or discounts of 10 percent or more generally are viewed as substantial; however, consideration should be given to the specific facts and circumstances. Additionally, we believe that when determining whether the debt involves a substantial premium or discount, consideration should be given to not only the relationship of the par amount to the issuance proceeds attributable to the debt, but also to the relationship of the payoff amount to the issuance proceeds attributable to the debt. As such, even when debt is issued at par, but a portion of the proceeds is allocated to other freestanding instruments (such as warrants) as described in Chapter 1, the debt could

be deemed to involve a substantial discount. Generally, it would not be appropriate to consider discounts created by separately recognizing a conversion option associated with the debt given that typically the holder would not benefit from the conversion option if the instrument is redeemed. However, it may be necessary to consider premiums or discounts created from bifurcating other embedded derivatives from the debt that could result in payments that are incremental to the redemption feature and can be triggered prior to or on the redemption date. Additionally, while fees paid to the creditor can create a discount that would be considered in this analysis, discounts related to issuance costs paid to third parties would be ignored in this analysis.

The guidance in ASC 815-15-25-26 is relevant to the analysis of noncontingent puts and calls and other features in a debt instrument that can alter the interest payments if the only underlying in the potential derivative is an interest rate or interest rate index. (As mentioned earlier, keep in mind that, if exercise of the option is contingent on the occurrence of a certain event, such as a change in control, this would constitute a non-interest rate underlying and, as such, ASC 815-15-25-26 would not be relevant to the analysis for that option.) When applicable, a conclusion would be reached under ASC 815-15-25-26 that an embedded feature is clearly and closely related to a debt host contract unless one of the following two conditions exists:

- There is a possible situation in which the creditor could be forced by the terms of the debt instrument to accept settlement in such a way that it would not recover substantially all of its initial recorded investment. (In practice, *substantially all* generally has been interpreted to mean at least 90 percent.) An example of when this condition would exist includes a situation whereby debt is issued at a premium greater than 10 percent and gives the debtor the option of prepaying at par.
- There is a possible future interest rate scenario under which the embedded derivative would at least double the creditor's initial rate of return on the debt instrument and result in a rate of return that would be at least twice the then-current market rate of return for a debt instrument with the same terms involving a debtor with similar credit quality at the inception of the debt. This condition does not apply if the right to accelerate the payment of the debt only can be exercised by the debtor.

In determining whether either of these two conditions exists, keep in mind that the analysis should be performed after allocating the proceeds to freestanding financial instruments that may have been issued together in the same transaction, such as warrants and debt.

Examples are provided in ASC 815-15-55-13 and ASC 815-15-55-25 to illustrate whether embedded put and call options are clearly and closely related to debt host contracts.

3.3.2.2 Criterion 3

The third criterion in the embedded derivative analysis necessitates determining whether a separate instrument with the same terms as the embedded derivative would be a derivative instrument subject to the requirements of ASC 815. Addressing this criterion involves determining whether the embedded feature meets the definition of a derivative as outlined beginning at ASC 815-10-15-83, and if so, whether it qualifies for one of the scope exceptions outlined in ASC 815-10-15-13.

Understanding the terminology

By definition, a derivative instrument has all of the following characteristics:

- One or more underlyings
- One or more notional amounts or payment provisions
- Requires no initial net investment or an initial net investment that is smaller than would be required for other types of contracts that would be expected to have a similar response to changes in market factors

- The contract can be settled net by any of the following means:
  - Its terms implicitly or explicitly require or permit net settlement.
  - It can readily be settled net by a means outside the contract.
  - It provides for delivery of an asset that puts the recipient in a position not substantially different from net settlement.

While an in-depth discussion of derivatives is beyond the scope of this guide, the following chart provides an indication of whether each characteristic likely would be met for standard conversion and redemption options in debt instruments or debt host contracts.

Characteristic	Conversion option	Redemption option
Underlying	Yes, the fair value of the shares into which it can be converted	Yes, the fair value of the debt host, which is a function of interest rates and credit risk. Additionally, if exercise of the option is contingent, the occurrence of the contingent event also would constitute an underlying.
Notional amount or payment provision	Yes, number of shares into which it can be converted	Yes, face or payoff amount
No or smaller initial net investment	Yes, the fair value (i.e., initial net investment) of the conversion option at inception is generally less than the fair value of the underlying shares.	Yes, the fair value (i.e., initial net investment) of the redemption option at inception is generally less than the fair value of the underlying debt.
Net settlement	Yes, if the conversion shares are readily convertible to cash, or contractually the conversion option can be settled net	Yes, due to ASC 815-10-15-107[7]
Scope exception that may be relevant	ASC 815-10-15-74(a), if the conversion option is indexed to the issuer's stock and classified in stockholders' equity as defined in ASC 815-40 and discussed in Sections 4.2.2.1 and 4.2.2.2 of this guide.	Put and call options in debt host contracts generally do not qualify for a scope exception.

As demonstrated in this chart, redemption features such as put and call options embedded in debt host contracts typically meet the definition of a derivative and generally are required to be recognized as such if the first and second criteria discussed in Sections 3.3.2 and 3.3.2.1 above also are met. Conversion options typically meet the definition of a derivative if net settlement exists, either contractually or because

[7] We believe net settlement also would exist under ASC 815-10-15-107 for conversion features in debt instruments that are in substance redemption options (i.e., the value of the feature is not expected to vary with changes in the fair value of the underlying shares).

the shares that would be delivered (conversion shares) if the option is exercised are readily convertible to cash. Contractual net settlement could result from a provision for the holder to receive the as-converted value in cash. For example, this may exist in the form of a noncontingent put or redemption option that allows the holder to receive the greater of the face amount or the as-converted value in cash.

If contractual net settlement does not exist for a conversion option, consideration should be given to whether the conversion shares are readily convertible to cash. This typically depends on whether the shares are publicly traded and, if so, the daily transaction volume.

Are the shares readily convertible to cash?

The determination of whether the shares are readily convertible to cash needs to be considered on an ongoing basis throughout a contract's life. Delisting, an IPO or significant changes in the level of trading activity are examples of factors that could influence the conclusion as consideration needs to be given to whether the smallest increment of shares that would be delivered in accordance with each individual contract is small relative to the daily transaction volume. Assume, for example, that a debt instrument can be converted at a conversion price that would result in the issuance of 100,000 shares of publicly traded common stock. The average daily trading volume associated with the common stock is 50,000 shares. If the debt instrument only could be converted in total, the 100,000 shares into which it would be converted is large relative to the daily transaction volume, and the common shares would not be considered to be readily convertible to cash. Many instruments permit conversion in whole or in part (i.e., in whatever increment the holder elects), in which case, generally, the common shares would be considered to be readily convertible to cash if they are actively traded. For additional information, refer to the guidance beginning at ASC 815-10-15-130 and Example 7 beginning at ASC 815-10-55-99.

Given that a conversion option is not clearly and closely related to a debt host contract, if a conclusion is reached that a conversion option is a derivative, consideration would next be given to ASC 815-40 to determine whether it qualifies for an exception to the derivative requirements by being both indexed to the issuer's stock and classified in stockholders' equity. If it does qualify for the exception, reference should be made to Section 3.3.4 of this guide. If the conversion option is a derivative that does not qualify for this exception, reference should be made to Section 3.3.3. Refer to the guidance in Section 5.2.2.1 and Section 5.2.2.2 in making this determination. In applying the guidance in Section 5.2.2.2, it is important to first determine whether the instrument is a conventional convertible debt instrument because the guidance in ASC 815-40-25-7 to 25-35 and ASC 815-40-55-2 to 55-6 that requires consideration of circumstances that can require net cash settlement is not applicable to conversion options that are embedded in conventional convertible debt.

What is a conventional convertible debt instrument?

As explained beginning at ASC 815-40-25-39, convertible debt, as well as certain mandatorily redeemable convertible preferred stock, meet the definition of a conventional convertible debt instrument if the holder can only realize the value of the conversion option by exercising the option and receiving the entire proceeds in a fixed number of shares or, at the issuer's discretion, the equivalent amount of cash. The number of shares is considered fixed even if the conversion rate is subject to standard antidilution adjustments. Careful attention should be given to circumstances under which the conversion rate may be adjusted, however, as it is not uncommon for convertible instruments to provide for adjustments that extend beyond standard antidilution events, in which case the instrument would not be considered conventional. (*Standard antidilution events* are defined to consist of equity restructuring events, such as a stock dividend, stock split, spinoff, rights offering or recapitalization through a large, nonrecurring cash dividend. Adjustments that would be made in the event the issuer issues shares at a price lower than the conversion price are not standard antidilution adjustments.)

3.3.2.3 Other potential embedded derivatives within debt host contracts

The following are other potential embedded derivatives within debt host contracts:

- *Default rate of interest.* ASC 815-15-25-46 makes it clear that derivative treatment is not appropriate for interest rates that are reset in the event of default, including violation of a credit-risk related covenant, a change in the debtor's published credit rating or change in creditworthiness (indicated by a change in its spread over U.S. Treasury bonds, for example). Careful consideration should be given to the default provisions within the agreement as it is not uncommon for the default rate of interest to be triggered in circumstances that are unrelated or not directly related to the creditworthiness of the debtor.
- *Interest based on shares.* Interest payments that are based on share prices or dividends paid on shares (whether shares of the debtor or other entities) may require bifurcation if they are a derivative within the scope of ASC 815 given that these features have characteristics and risks that are associated with an equity host contract rather than a debt host contract.
- *Payments based on sales or other performance measures.* ASC 815-10-15-59 includes a scope exception to derivative recognition that applies to embedded features if the underlying on which settlement is based is specified volumes of sales or service revenues of one of the parties to the contract. While this scope exception does not apply to payments based on changes in sales or revenues due to changes in market prices, it is evident from the example in ASC 815-15-55-10 that, in addition to volume of sales or service revenues, the scope exception applies to payments based on a portion of net earnings or operating cash flows. Generally, if contingent payments such as these do not require derivative recognition, they are accounted for in accordance with the guidance in ASC 470-10-25, if relevant, and if not, ASC 450.

3.3.3 Accounting treatment if derivative recognition is required – Before adoption of ASU 2020-06

If an embedded feature, such as a conversion or redemption option, requires separate recognition as a derivative asset or liability under ASC 815, it is initially and subsequently measured and carried at fair value, with changes in fair value reflected in earnings in accordance with ASC 815-15-30 and ASC 815-10-35. (Refer to Sections 1.4 and 1.5, as applicable, for a discussion related to the initial recognition and fair value determinations.) The allocation of proceeds to separately recognized derivatives generally will result in the debt carrying amount being less than its face amount, creating a discount that should be amortized using the interest method as discussed in Section 3.5.

3.3.3.1 Conversion, modification or extinguishment of the debt instrument for which a conversion option was recognized as a derivative

3.3.3.1.1 Conversion. In those circumstances where the conversion feature was required to be bifurcated and accounted for as a derivative liability at fair value, there is no equity conversion feature remaining in the debt instrument for accounting purposes. Therefore, while there may be a legal conversion of the debt, for accounting purposes both the debt host contract and the bifurcated conversion feature are subject to extinguishment accounting because these liabilities are being satisfied in exchange for shares. As such, in general, a gain or loss upon extinguishment equal to the difference between the recorded value of the liabilities and the fair value of the shares issued to extinguish them should be recorded.

Accounting for the conversion of convertible debt when the conversion feature was separately recognized as a derivative liability requires the following three steps:

1. Update the valuation of the conversion feature and any other bifurcated derivatives to the legal conversion date through earnings as necessary. (Note that if conversion occurred on the expiration date of the conversion feature, the fair value likely would be the intrinsic value on that date.

Otherwise, an option pricing model that gives consideration to the remaining exercise period generally would be used to estimate the fair value. We have observed diversity in practice in that some entities adjust the conversion feature to intrinsic value rather than fair value at the conversion date. The impact to the income statement in total should be the same as the impact of adjusting the carrying value of the feature to intrinsic value rather than fair value, given that the gain or loss on extinguishment will change accordingly.)

2. Adjust the carrying value of the host debt instrument through interest expense if necessary to bring the amortization or accretion of any premiums, discounts or unamortized issuance costs up to date as of conversion.

3. Recognize the difference between the fair value of the shares that are issued in satisfaction of the debt and the updated net carrying amount of the debt (with consideration given to any remaining unamortized premiums, discounts and issuance costs) and conversion feature as an extinguishment gain or loss.

The following example illustrates the entries under the two alternatives discussed in Step 1.

Example: Accounting for the conversion of debt for which the conversion option was recognized as a derivative

Assume that debt with a face amount of $10,000 and a maturity date in 20X5 was converted in full on December 31, 20X4. The fair value of the conversion feature estimated using an option pricing model decreased by $100 since the most recent valuation date to $500 as of the conversion date. The intrinsic value of the conversion feature as of the conversion date was $400 determined as the excess of the value of the common shares at that date over the conversion price. A discount on the debt was created through the recognition of the conversion feature as a derivative at the issuance date. Assume that on the conversion date, the net carrying amount of the debt after the accretion of the issuance-date discount to the conversion date was $9,500.

	Adjust conversion feature to fair value		Adjust conversion feature to intrinsic value	
	Debit	**Credit**	**Debit**	**Credit**
Adjust carrying amount of derivative to conversion date value				
Derivative liability	$100		$200	
Other income		$100		$200
Record common stock at fair value and remove debt and related derivative				
Debt	$9,500		$9,500	
Derivative liability	500		400	
Loss on extinguishment	400		500	
Common stock (par and additional paid-in capital)		$10,400		$10,400
Net impact to income statement	**$300**		**$300**	

3.3.3.1.2 Modification or extinguishment. For a discussion of modification and extinguishment considerations related to convertible debt instruments in general, refer to Section 3.4.4.1 of this guide as well as our debt modifications and restructurings guide. As is noted at ASC 470-50-40-11, the guidance in ASC 470-50-40-10 specific to conversion options does not pertain to convertible instruments for which the conversion option is separately accounted for as a derivative. As such, there is no guidance that specifically addresses the accounting for the modification of such an instrument. Given that the

conversion option is separated from the debt, we believe the cash flows test in ASC 470-50-40-10 should be applied to the debt instrument ignoring the conversion feature, particularly in those circumstances in which the conversion option requires separate recognition as a derivative both before and after the modification. Any changes in the fair value of the conversion option that are associated with a modification will be recognized in earnings as the carrying amount of the conversion option is adjusted to its fair value post modification. The extinguishment of a convertible debt instrument for which the conversion option is separately accounted for as a derivative is addressed in the example in Section 3.3.3.1.1.

3.3.4 Accounting treatment if derivative recognition is not required – Before adoption of ASU 2020-06

An embedded feature that does not require derivative recognition is not given separate recognition unless required under ASC 470-20. This subtopic is discussed in Section 3.4 of this guide and applies to conversion options that are not required to be accounted for as derivatives. In the event a redemption option is exercised, extinguishment accounting should be applied. Refer to the relevant sections that follow related to the accounting upon conversion.

3.3.5 Ongoing need for reassessment of derivative conclusions – Before adoption of ASU 2020-06

As pointed out in ASC 815-40-35-8, there is an ongoing need to reassess certain conclusions that were reached related to potential embedded derivatives. For example, reassessment would be necessary if the terms of an instrument are modified.

Absent modification of any terms, the primary circumstances necessitating reassessment for debt instruments or debt host contracts relate to conversion options and conclusions reached on whether they meet the definition of a derivative, and if so, whether they qualify for the scope exception in ASC 815-10-15-74(a) by being indexed to the entity's own stock (as addressed in Section 5.2.2.1 of this guide) and meeting the requirements to be classified in equity (as addressed in Section 5.2.2.2 of this guide). Specifically, if derivative treatment hinged on the conclusion reached on whether the conversion shares are readily convertible to cash as discussed in Section 3.3.2.2, as pointed out in ASC 815-10-55-84, this conclusion should be reassessed on an ongoing basis given that this conclusion could change for various reasons, including an IPO, sustained changes in daily trading value and listing or delisting of the shares on a national stock exchange. Increased trading activity could result in a conclusion that a conversion option that initially was not a derivative now is, and vice versa.

In reassessing whether conversion options that are deemed to be derivatives qualify for the previously mentioned scope exception, ongoing consideration needs to be given to the requirements for equity classification as summarized in Section 5.2.2.2, unless the instrument is a conventional convertible debt instrument as defined earlier. If, for example, the conclusion changes related to whether an entity can demonstrate it has sufficient authorized shares to settle the conversion option, reclassification may be necessary.

Additionally, there may be circumstances that cause the conclusion to change related to whether a feature is considered indexed to the entity's stock as summarized in Section 5.2.2.1. This may be the case, for example, if the conversion terms are subject to adjustment for a limited period of time, because after the terms are no longer subject to adjustment, the conversion feature may be indexed to the entity's stock. It generally is not appropriate to reassess conclusions reached related to the first criterion discussed in Section 3.3.2.1, unless the instrument is subsequently modified.

3.3.5.1 Conversion option subsequently requires derivative recognition

If, upon reassessment, a conversion option that was not previously required to be recognized as a derivative requires derivative recognition, the fair value of that conversion option would be recognized as

a liability at its fair value on that date. It would continue to be subsequently measured at fair value with changes in fair value recognized through earnings.

There is little guidance that specifically addresses what should be debited in establishing the derivative liability. ASC 815-40-35-9 indicates that, if a contract is reclassified from permanent or temporary equity to an asset or a liability, the change in fair value of the contract during the period the contract was classified as equity should be accounted for as an adjustment to stockholders' equity. Similarly, in the context of instruments subject to the scope of the Cash Conversion subsections of ASC 470-20 (discussed in Section 3.4.1 of this guide), ASC 470-20-35-19 indicates that, if a conversion option is required to be reclassified from stockholders' equity to a liability measured at fair value, the difference between the amount previously recognized in equity and the fair value of the conversion option on the date of reclassification should be accounted for as an adjustment to stockholders' equity. It may be reasonable to apply a similar approach to instruments for which a beneficial conversion feature (as discussed in Section 3.4.2) previously was recognized in equity. In the event no portions of the convertible debt previously were recognized in equity due to the application of ASC 470-20, we believe the debt carrying amount should be debited in creating the derivative liability and that the discount this creates should be amortized using the interest method over the remaining life of the instrument.

3.3.5.2 Conversion option no longer requires derivative recognition

If a conversion option previously was recognized as a derivative, and upon reassessment no longer should be, ASC 815-15-35-4 indicates that the carrying amount of the conversion option (fair value on the reclassification date) should be reclassified from a liability to shareholders' equity without subsequent adjustment to fair value. The debt discount that was created when the conversion option originally was recognized as a derivative should continue to be amortized. In the event the holder elects to exercise the conversion option, any remaining unamortized discount should be recognized as interest expense upon conversion in accordance with ASC 815-15-40-1. If the instrument is extinguished before its stated maturity date rather than converted, the reacquisition price needs to be allocated to both the equity and debt components of the instrument to determine the gain or loss on extinguishment. Namely, a portion of the reacquisition price equal to the fair value of the conversion option at the date of the extinguishment is allocated to equity with the remainder allocated to the extinguishment of the debt in accordance with ASC 815-15-40-4.

3.4 ASC 470-20 considerations if the debt instrument is convertible – Before adoption of ASU 2020-06

If a conversion option embedded in a convertible instrument does not require separate recognition as a derivative, the guidance in ASC 470-20 should be considered to determine whether a portion of the convertible instrument's proceeds should be recognized in equity as additional paid-in capital. This could be required if a cash conversion or beneficial conversion feature exists as discussed in Section 3.4.1 and Section 3.4.2, respectively. Additionally, in circumstances whereby convertible debt is issued at a substantial premium, it generally is appropriate to recognize the premium in its entirety as additional paid-in capital as discussed in Section 3.4.3. Lastly, Section 3.4.4 addresses the accounting for a convertible debt instrument when no separate recognition is warranted for the conversion option.

In the event it is necessary to recognize a portion of the proceeds associated with a convertible instrument in equity, as indicated in ASC 470-20-25-21, the fair value option under ASC 825 cannot be elected for that instrument.

3.4.1 Cash Conversion subsections of ASC 470-20 – Before adoption of ASU 2020-06

3.4.1.1 Application and initial recognition

As explained in ASC 470-20-15-4, the Cash Conversion subsections of ASC 470-20 apply to convertible debt instruments that may be settled in cash or other assets upon conversion. (Keep in mind that, if a convertible debt instrument requires, rather than permits, the issuer to settle the obligation in cash based

on the conversion value, the conversion option would require derivative recognition, and ASC 470-20 would not be relevant.) This guidance also applies to convertible preferred shares that are mandatorily redeemable and classified as a liability under ASC 480. (An example of such an instrument is described in ASC 470-20-55-70 as a convertible preferred share that has a stated redemption date and also requires the issuer to settle the face amount of the instrument in cash if the conversion option is exercised.) As is pointed out in ASC 470-20-15-5, this guidance does not apply to convertible debt instruments that require or permit settlement in cash (or other assets) upon conversion only in specific circumstances in which the holders of the underlying shares would receive the same form of consideration.

For those instruments subject to the Cash Conversion subsections of ASC 470-20, a portion of the convertible instrument's proceeds are classified in equity. This portion is determined in accordance with ASC 470-20-30-27 and 30-28, which require estimating the fair value of a similar liability that does not have an associated equity component and subtracting that value from the initial proceeds ascribed to the convertible debt instrument as a whole. This allocation of proceeds to an equity component impacts the amount of discount or premium on the debt instrument and ongoing amortization or accretion.

Example: Accounting for the issuance of an instrument with a cash conversion feature

Assume Entity A issues for proceeds of $1 million notes that can be converted at any time into a specified number of shares. Upon conversion, Entity A has the option to settle the if-converted value in cash, common stock or any combination of the two. Assuming the conversion option does not require separate accounting as a derivative, the accounting would be governed by ASC 470-20. Assume the fair value of the notes ignoring the conversion option is estimated to be $600,000 at the issuance date. The entry to record the issuance would be as follows, ignoring deferred tax considerations:

	Debit	Credit
Cash	$1,000,000	
Debt discount	400,000	
Debt		$1,000,000
Additional paid-in capital		400,000

The example in Section 3.4.1.4 also illustrates the initial issuance and other accounting for this type of instrument.

When accounting for the issuance of the instrument, additional considerations to keep in mind include:

- In accordance with ASC 470-20-25-26, transaction costs incurred with third parties should be allocated to the liability and equity components in proportion to the allocation of proceeds and accounted for as debt issuance costs and equity issuance costs, respectively.
- The recognition of a portion of the debt proceeds as equity creates a basis difference associated with the liability component and generates a temporary difference for tax purposes. As indicated in ASC 470-20-25-27, the initial recognition of deferred taxes attributable to this temporary difference should be accounted for as an adjustment to additional paid-in capital.
- The SEC staff guidance in ASC 480-10-S99-3A should be considered to determine whether the equity-classified component should be classified as temporary equity. This would be the case if, as of the balance sheet date, the issuer can be required to settle the convertible debt instrument for cash or other assets (i.e., the instrument is currently redeemable or convertible for cash or other assets). The portion of the equity-classified component that is presented in temporary equity (if any) is measured as the excess of the amount of cash or other assets that would be required to be paid to the holder upon redemption or conversion over the current carrying amount of the liability-classified component

of the convertible debt instrument. For example, if the convertible debt instrument is currently redeemable at the option of the holder for $1,000 in cash, and the liability-classified component of the instrument has a carrying amount of $950, $50 of the equity-classified component should be presented as temporary equity.

3.4.1.2 Subsequent measurement

ASC 470-20-35-12 to 35-17 addresses the subsequent measurement of instruments within the Cash Conversion subsections of ASC 470-20, which is illustrated in the example in Section 3.4.1.4 of this guide. In accordance with this guidance, the amount allocated to additional paid-in capital at the issuance date is not subsequently adjusted for changes in fair value or otherwise, as long as the conversion option continues to not require derivative accounting. (Refer to Section 3.3.5 regarding the need to continuously reassess this conclusion.) The debt discount is amortized into interest expense over the expected life of the debt instrument using the interest method. The expected life should be based on a similar liability that does not have an associated equity component, but considers the effects of embedded features other than the conversion option unless those features are nonsubstantive (i.e., it is probable at the issuance date of the debt instrument that the embedded feature will not be exercised). If an income approach valuation technique is used to measure the fair value of the liability component at initial recognition, the expected life used to amortize the discount should be consistent with the expected life used in the fair value measurement. This expected life should not be reassessed in subsequent periods unless the terms of the instrument are modified.

3.4.1.3 Derecognition

If an instrument subject to the scope of the Cash Conversion subsections of ASC 470-20 is derecognized (whether through conversion, extinguishment or otherwise), the consideration transferred and transaction costs incurred should be allocated as an extinguishment of the liability component and the reacquisition of the equity component. Such an allocation involves the following steps as outlined in ASC 470-20-40-20 and illustrated in the example at Section 3.4.1.4 of this guide:

- Measure the fair value of the consideration transferred to the holder. (Consideration could include cash, shares or, if the transaction is a modification or exchange that is accounted for as an extinguishment of the original instrument, a new debt instrument.)
- Allocate consideration equal to the fair value of the liability component immediately prior to extinguishment to the liability component.
- Recognize a gain or loss on extinguishment for the difference between the consideration allocated to the liability component and the sum of the net carrying amount of the liability component and any unamortized debt issuance costs.
- Allocate the remaining consideration to the reacquisition of the equity component and recognize it as a reduction to stockholders' equity (additional paid-in capital).

Transaction costs incurred with third parties that directly relate to the settlement of the instrument should be allocated to the liability and equity components in proportion to the allocation of consideration transferred at settlement and accounted for as debt extinguishment and equity reacquisition costs, respectively, in accordance with ASC 470-20-40-22. If the conversion option expires out of the money and the instrument is paid off at its face amount in cash, there would be no gain or loss on settlement, given that the fair value of the liability component would be its face amount and there would be no consideration allocated to the equity component.

3.4.1.3.1 Modifications and exchanges. If an instrument within the scope of the Cash Conversion subsections of ASC 470-20 is modified, the guidance in ASC 470-50 should be considered to determine whether the transaction should be accounted for as a modification or extinguishment. If modification accounting is appropriate, the expected life of the liability component should be reassessed as outlined in

ASC 470-20-40-23, and a new effective interest rate determined in accordance with the guidance in ASC 470-50. If, upon modification, the conversion option no longer requires or permits cash settlement upon conversion, the components of the instrument should continue to be accounted for separately, unless the modification is required to be accounted for as an extinguishment. If extinguishment accounting is required and the new instrument is a convertible debt instrument, the new instrument would be analyzed to determine whether the conversion option should be separately recognized as a derivative, and if not, whether ASC 470-20 applies.

If a modified instrument that was not previously within the scope of the Cash Conversion subsections of ASC 470-20 becomes subject to this guidance as a result of modifications that are not required to be accounted for as an extinguishment of the original instrument, the liability component is measured at its fair value as of the modification date, and the carrying amount of the equity component is the residual of the overall carrying amount of the convertible debt instrument as a whole. A portion of any unamortized debt issuance costs should be reclassified and accounted for as equity issuance costs. This portion should be based on the proportion of the overall carrying amount of the convertible debt instrument that is allocated to the equity component in accordance with ASC 470-20-40-25.

3.4.1.3.2 Induced conversions. ASC 470-20-40-26 addresses induced conversions and provides that, in the event the terms of an instrument within the scope of the Cash Conversion subsections of ASC 470-20 are modified to induce early conversion (e.g., a more favorable conversion ratio or additional consideration is offered in the event conversion is elected before a specified date), the entity should recognize a loss equal to the fair value of all securities and other consideration transferred in the transaction in excess of the fair value of consideration issuable in accordance with the original conversion terms. The derecognition treatment described in Section 3.4.1.3 of this guide is then applied using the fair value of the consideration that was issuable in accordance with the original conversion terms. The guidance in this paragraph does not apply to derecognition transactions in which the holder does not exercise the embedded conversion option.

3.4.1.4 Comprehensive example

The following comprehensive example of the issuance, subsequent measurement and extinguishment of an instrument within the scope of the Cash Conversion subsections of ASC 470-20 was adapted from the illustration beginning at ASC 470-20-55-71. For purposes of this example, assume the embedded conversion option does not require separate accounting as a derivative instrument because it qualifies for the scope exception discussed in Section 3.3.2.2 of this guide by being indexed to the issuer's stock and classified in stockholders' equity. Transaction costs have been omitted from this example, and journal entry amounts have been rounded to the nearest thousand.

Assumptions: On January 1, 2X07 Company A issues 100,000 convertible notes at their par value of $1,000 per note, raising total proceeds of $100,000,000. The notes bear interest at a fixed rate of 2% per annum, payable annually in arrears on December 31, and are scheduled to mature on December 31, 2X16. Each $1,000 par value note is convertible at any time into the equivalent of 10 shares of Company A's common stock (i.e., a stated conversion price of $100 per share). The quoted market price of Company A's common stock is $70 per share on the date of issuance. Upon conversion, Company A can elect to settle the entire if-converted value (i.e., the principal amount of the debt plus the conversion spread) in cash, common stock, or any combination thereof.

Recognition and initial measurement: Upon issuance, the fair value of the liability component is estimated by calculating the present value of its cash flows using a discount rate of 8% (an assumed market rate for similar notes that have no conversion rights). The equity component is determined by subtracting the liability component from the total proceeds. These computations are as follows:

Present value of the principal—$100,000,000 payable in ten years	$46,319,349
Present value of interest—$2,000,000 payable annually in arrears for ten years	13,420,163
Total liability component	$59,739,512
Total equity component ($100,000,000 – $59,739,512)	$40,260,488

Company A records the following entries at initial recognition, assuming a tax rate of 40%.

Cash	$100,000,000	
Debt discount	40,260,000	
Debt		$100,000,000
Additional paid-in capital		40,260,000

Additional paid-in capital	$16,104,000	
Deferred tax liability ($40,260,000 × 40%)		$16,104,000

Subsequent measurement: The notes do not contain embedded prepayment features other than the conversion option, so Company A concludes that the expected life of the notes is ten years (consistent with the periods of cash flows used to measure the fair value of the liability component) for purposes of applying the interest method. During the five-year period from January 1, 2X07, through December 31, 2X11, Company A records entries that total the following.

Interest expense	$26,304,000	
Cash		$10,000,000
Debt discount		16,304,000

Taxes payable	$4,000,000	
Deferred tax liability	6,522,000	
Current tax benefit ($10,000,000 × 40%)		$4,000,000
Deferred tax benefit ($16,304,000 × 40%)		6,522,000

Derecognition: Assume on January 1, 2X12, when the quoted market price of Company A's common stock is $140 per share, all holders of the convertible notes exercise their conversion options. Accordingly, those investors are entitled to aggregate consideration of $140,000,000 ($1,400 per note). At settlement, the market interest rate for similar debt without a conversion option is 7.5%. Company A receives no tax deduction for the payment of consideration upon conversion ($140,000,000) in excess of the tax basis of the convertible notes ($100,000,000), regardless of the form of that consideration (cash or shares).

Upon settlement of the notes, the fair value of the liability component immediately prior to extinguishment is measured first, and the difference between the fair value of the aggregate consideration remitted to the holder ($140,000,000) and the fair value of the liability component is attributed to the reacquisition of the equity component.

The fair value of the liability component (which has a remaining term of five years at the settlement date) is estimated by calculating the present value of its cash flows using a discount rate of 7.5%, the market rate for similar notes that have no conversion rights, as shown below.

Present value of the principal—$100,000,000 payable in five years	$69,655,863
Present value of interest—$2,000,000 payable annually in arrears for five years	8,091,770
Consideration attributed to liability component	$77,747,633
Consideration attributed to equity component ($140,000,000 – $77,747,633)	$62,252,367

Regardless of the form of the $140,000,000 of consideration transferred at settlement, $77,747,633 would be attributed to the extinguishment of the liability component and $62,252,367 would be attributed to the reacquisition of the equity component. The carrying amount of the liability is $76,043,740 ($100,000,000 principal – $23,956,260 unamortized discount) at the December 31, 2X11, settlement date, resulting in a $1,703,893 loss on extinguishment.

Entries recorded at settlement, under 3 different scenarios are as follows.

Scenario 1: Company A elects to transfer consideration to the holder in the form of $100,000,000 cash and 285,714 shares of common stock (with a fair value of $40,000,000). The $62,252,367 decrease to

additional paid-in capital for the reacquisition of the conversion option, the $39,997,143 increase to additional paid-in capital from the issuance of common stock at conversion, and the $8,900,947 increase to additional paid-in capital to reverse the deferred tax liability relating to the unamortized debt discount at conversion, adjusted for the loss on extinguishment, are presented on a gross basis in this journal entry for illustrative purposes.

Debt	$100,000,000	
Additional paid-in capital—conversion option	62,252,000	
Loss on extinguishment	1,704,000	
Deferred tax liability	9,583,000	
Debt discount		$23,956,000
Cash		100,000,000
Common stock at par of $.01 per share		3,000
Additional paid-in capital—share issuance		39,997,000
Deferred income tax benefit ($1,704,000 × 40%)		682,000
Additional paid-in capital [($23,956,000 – $1,704,000) × 40%]		8,901,000

Scenario 2: Company A elects to transfer consideration to the holder in the form of $140,000,000 cash.

Debt	$100,000,000	
Additional paid-in capital—conversion option	62,252,000	
Loss on extinguishment	1,704,000	
Deferred tax liability	9,583,000	
Debt discount		$23,956,000
Cash		140,000,000
Deferred income tax benefit ($1,704,000 × 40%)		682,000
Additional paid-in capital [($23,956,000 – $1,704,000) × 40%]		8,901,000

Scenario 3: Company A elects to transfer consideration to the holder in the form of 1 million shares of common stock (with a fair value of $140,000,000).

Debt	$100,000,000	
Additional paid-in capital—conversion option	62,252,000	
Loss on extinguishment	1,704,000	
Deferred tax liability	9,583,000	
Debt discount		$23,956,000
Common stock at par of $.01 per share		10,000
Additional paid-in capital—share issuance		139,990,000
Deferred income tax benefit ($1,704,000 × 40%)		682,000
Additional paid-in capital [($23,956,000 – $1,704,000) × 40%]		8,901,000

3.4.2 Beneficial conversion features provisions of ASC 470-20 – Before adoption of ASU 2020-06

3.4.2.1 Application and initial recognition

The guidance in ASC 470-20 pertaining to beneficial conversion features applies to both convertible debt and convertible preferred stock and provides for the intrinsic value of conversion options that are in the money at the commitment date, or upon the occurrence of a future event, to be recognized as additional paid-in capital. This guidance should be considered if the conversion feature in a convertible instrument is not required to be accounted for as a derivative under ASC 815 (discussed in Section 3.3 of this guide) and is not within the scope of the Cash Conversion subsections of ASC 470-20 (discussed in Section

3.4.1 of this guide). This guidance also applies to warrants to purchase convertible preferred stock as more fully discussed in Section 5.2.3.

Determining the commitment date in accordance with ASC 470-20-30-9 to 30-12

The determination of the commitment date is important, particularly for highly volatile stock that can have significant swings in value from day to day. The commitment date is the date on which an agreement has been reached that meets the definition of a firm commitment. For a firm commitment to exist, there must be a binding and legally enforceable agreement that specifies all significant terms and includes a sufficiently large disincentive for nonperformance (e.g., a statutory right to pursue remedies for default equivalent to the damages suffered) that makes performance probable.

If the agreement includes subjective provisions that permit either party to rescind its commitment, the commitment date does not occur until the earlier of the date the provisions expire or the convertible instrument is issued. It is not uncommon for agreements to have subjective provisions, such as material adverse change clauses, or for the commitments to be subject to customary due diligence or shareholder approval. For this reason, in many cases, the commitment date is the date the instrument is issued.

The allocation of proceeds to additional paid-in capital for the intrinsic value effectively creates a discount on the convertible instrument that needs to be amortized using the interest method.

3.4.2.1.1 Illustration of the computation and recognition of a beneficial conversion feature. An illustration of the computation and recognition of a beneficial conversion feature follows, adapted from the example beginning at ASC 470-20-55-29.

Assumptions:

a. $1,000,000 of convertible debt with a redemption date on the fifth anniversary of issuance

b. Convertible at date of issuance

c. Convertible at $40 per share

d. Fair value of common shares at commitment date equals $50 per share

Calculation

Fair value of shares at commitment date	$50
Conversion price	$40
Intrinsic value of beneficial conversion feature	$10
Number of shares (1,000,000 ÷ 40)	25,000
Beneficial conversion feature	$250,000

Entry at date of issuance

Cash	$1,000,000	
Debt discount	250,000	
Debt		$1,000,000
Additional paid-in capital		250,000

Because the debt has a stated redemption on the fifth anniversary of issuance, the debt discount should be amortized (in accordance with the guidance in Section 3.5) over a five-year period from the date of issuance to the stated redemption date. It should be noted that this entry would be recorded at issuance even if the instrument was not convertible until a later date, as long as conversion is contingent solely on the passage of time.

3.4.2.1.2 Determining the effective conversion price. When convertible instruments are issued with other freestanding instruments, such as warrants, it is first necessary to allocate the proceeds amongst the convertible instrument and the other freestanding instruments to determine the effective conversion price in accordance with ASC 470-20-30-5 when computing the value of the beneficial conversion feature. (Refer to Chapter 1 for additional guidance on determining freestanding instruments and allocating proceeds.) This process in effect creates a beneficial conversion feature for an instrument for which the conversion price was set to be at market on the commitment date. An illustration follows, adapted from the example beginning at ASC 470-20-55-10.

> Assume Entity A issues for $1 million convertible debt with a par amount of $1 million and 100,000 detached warrants. (Assume that the warrants meet the requirements to be classified in equity.) The convertible debt is convertible at a conversion price of $10 per share, and the holder would receive 100,000 shares of Entity A common stock upon conversion. The fair value of Entity A's stock at the commitment date is $10. The ratio of the relative fair value of the convertible debt and the detached warrants is 75 to 25. After allocating 25 percent or $250,000 of the proceeds to the detached warrants, the convertible debt is recorded on the balance sheet at $750,000 (net of the discount that arises from the allocation of proceeds to the warrants). The computations of the effective conversion price and the intrinsic value are as follows.

Value of the shares	$10.00
Effective conversion price ($750,000/100,000 shares to be received)	$7.50
Difference, intrinsic value per share	$2.50
Amount to be recognized as additional paid-in capital ($2.50 x 100,000 shares to be received)	$250,000

> The following entry would be recorded.

Cash	$1,000,000	
Debt discount	500,000	
Debt		$1,000,000
Additional paid-in capital – Warrants		250,000
Additional paid-in capital – Beneficial conversion feature		250,000

> As this entry illustrates, the allocation of proceeds to the warrants and a beneficial conversion feature in total create a $500,000 discount on the debt that will be amortized into interest expense over the life of the debt using the interest method illustrated in Section 3.5 of this guide.

3.4.2.1.3 Additional considerations related to the initial recognition of a beneficial conversion feature. When computing the amount of the beneficial conversion feature and accounting for the issuance of the instrument, additional considerations to keep in mind include:

- As outlined in ASC 470-20-30-13, issuance costs incurred with parties other than the investor should not affect this computation; however, amounts paid to the investor would reduce the proceeds and therefore would be considered in the computation
- A contingent beneficial conversion feature is not recognized until the contingency is resolved. (Refer to Section 3.4.2.2.1 for related discussion.)
- The beneficial conversion feature that is recognized (either at issuance or upon the lapse of a contingency, as discussed later) is limited to the amount of proceeds that are allocated to the convertible instrument in accordance with ASC 470-20-30-8.
- As outlined in ASC 470-20-30-7, if the convertible instrument contains more than one conversion rate, the computation should be made using the most favorable conversion price that would be in effect at

the conversion date, assuming there are no changes to the current circumstances except for the passage of time. This is illustrated in the example in Section 3.4.2.2.1.3.1 in this guide.

- ASC 470-20-30-19 indicates that if the convertible instrument is issued as repayment of a nonconvertible instrument, and the nonconvertible instrument has matured, the fair value of the newly issued convertible instrument (and therefore the proceeds for the purpose of determining whether a beneficial conversion feature exists) is assumed to be the redemption amount owed at the maturity date of the original instrument (assuming this exchange is not a troubled debt restructuring as defined in ASC 470-60).
- The recognition of a portion of the debt proceeds as equity creates a basis difference associated with the liability component and generates a temporary difference for tax purposes. ASC 740-10-55-51 provides for the initial recognition of deferred taxes attributable to this temporary difference to be accounted for as an adjustment to additional paid-in capital.
- The SEC staff guidance in ASC 480-10-S99-3A should be considered to determine whether any equity-classified component should be classified as temporary equity. This would be the case if, as of the balance sheet date, the issuer can be required to settle the convertible instrument for cash or other assets (i.e., the instrument is currently redeemable or convertible for cash or other assets). The portion of the equity-classified component that is presented in temporary equity (if any) is measured as the excess of the amount of cash or other assets that would be required to be paid to the holder upon redemption or conversion over the current carrying amount of the liability-classified component of the convertible debt instrument. For example, if the convertible debt instrument is currently redeemable at the option of the holder for $1,000 in cash, and the liability-classified component of the instrument has a carrying amount of $950, $50 of the equity-classified component should be presented as temporary equity.

3.4.2.1.4 Dividends or interest paid in kind. If dividends or interest are paid in kind (i.e., as additional instruments that are convertible), consideration should be given to the guidance in ASC 470-20-30-16 to 30-18 in determining whether it is necessary to recognize a beneficial conversion feature as the interest and dividends are accrued or declared. If the payment of dividends or interest in kind is discretionary, the fair value of the conversion shares at the time the interest or dividends are accrued in comparison to the amount of the interest or dividends is used to compute the beneficial conversion feature. If payment in kind is not discretionary, the fair value of the conversion shares at the commitment date for the original instrument in comparison to the amount of the interest or dividends is used to compute the beneficial conversion feature. Payment in kind is **not** discretionary if both of the following conditions exist: (a) neither the issuer nor the holder can elect other forms of payment (e.g., cash) for the dividends or interest, and (b) if the original instrument or a portion thereof is converted before accumulated dividends or interest are declared or accrued, the holder will always receive the number of shares upon conversion as if all accumulated dividends or interest have been paid in kind.

3.4.2.2 Subsequent measurement

The amount recorded as additional paid-in capital related to a beneficial conversion feature is not subject to subsequent adjustment unless a contingent event occurs that makes a new conversion option exercisable or results in an adjustment to the conversion price. (Refer to Section 3.4.2.2.1.) Any discount created through the recognition of a beneficial conversion feature should be amortized in accordance with ASC 470-20-35-7 as follows:

- If the convertible instrument has a stated redemption date, the discount should be amortized from the date of issuance to the stated redemption date, regardless of when the earliest conversion date occurs.
- If the instrument involves a multiple-step discount and does not have a stated redemption date, the discount should be amortized over the minimum period in which the investor can recognize that

return. However, recognized amortization may require adjustment to ensure that the discount amortized at any point in time is not less than the amount the holder of the instrument could obtain if conversion occurred at that date. (In other words, cumulative amortization should be equal to the greater of (a) the amount derived using the effective yield method based on the conversion terms most beneficial to the investor or (b) the amount of discount the investor can realize at that interim date.) An example from the guidance beginning at ASC 470-20-55-69 follows.

> If an instrument provides for a 15 percent discount to the market price after 3 months, a 25 percent discount after 6 months, a 35 percent discount after 9 months, and a 40 percent discount after 1 year, paragraph 470-20-30-15 requires that the computation of the intrinsic value be made using the conversion terms that are most beneficial to the investor; that is, the discount would be 40 percent and the amortization period would be 1 year. However, paragraph 470-20-35-7 indicates that the amortization recognized may require adjustment to ensure that the discount amortized at any point in time is not less than the amount the holder of the instrument could obtain if conversion occurred at that date. That is, at the end of 3 months, at least the 15 percent discount should have been recognized. Paragraph 470-20-35-7(a) states that, if a convertible instrument has a stated redemption date, the discount shall be accreted from the date of issuance to the stated redemption date of the convertible instrument, regardless of when the earliest conversion date occurs.

- If there is no stated redemption date and no multiple-step discount, the discount is amortized over the period to the instrument's earliest conversion date.

The discount is amortized (using the interest method illustrated in Section 3.5) to interest expense if the convertible instrument is a debt instrument, and to retained earnings if the convertible instrument is an equity instrument (or additional paid-in capital if there is a deficit in retained earnings).

3.4.2.2.1 Contingent conversion options and conversion prices that reset. It is not uncommon for convertible instruments to become convertible only upon the occurrence of a future event (i.e., are contingently convertible) or to have a contingently adjustable conversion ratio. Common examples of a contingently adjustable conversion price include conversion prices that will reset to an IPO price or upon a subsequent round of financing at a price lower than the original conversion price. (It should be noted that, prior to the adoption of ASU 2017-11, adjustments like this typically cause the conversion option to not be indexed to the entity's own stock as discussed in Section 5.2.2.1, in which case the conversion option would need to be recognized as a derivative if it meets the criteria in ASC 815-15-25-1 discussed in Section 3.3.2.2, and the guidance in this section would not be relevant.) If an instrument becomes convertible only upon the occurrence of a future event outside the control of the holder, or the instrument is convertible from inception, but contains conversion terms that change upon the occurrence of a future event, any contingent beneficial conversion feature is measured using the commitment date stock price, but not recognized until the contingency is resolved as outlined in ASC 470-20-35-2 and 35-3. The intrinsic value (or additional intrinsic value if a beneficial conversion feature was previously recognized on the instrument) is recognized as additional paid-in capital with a corresponding discount to the convertible instrument that should be subsequently amortized as discussed in the preceding section of this guide. As noted in ASC 470-20-30-8, the beneficial conversion feature is limited to the proceeds allocated to the convertible instrument. We believe that, when an additional contingent beneficial conversion feature or features are triggered, this limitation would apply to the cumulative amount of beneficial conversion feature recognized.

In accordance with ASC 470-20-35-1, as it relates to a contingent conversion option, if the number of shares that the holder would receive if the contingent event occurs and the conversion price is adjusted cannot be computed, once the contingent event occurs and the number of shares that could be received is known, the excess of this number of shares over the number of shares the holder would have received prior to the adjustment is multiplied by the commitment date stock price to derive the intrinsic value. That value is recognized as a beneficial conversion feature when the triggering event occurs. Computing the intrinsic value in this manner can result in the determination that a beneficial conversion feature exists, even though the adjusted conversion price is greater than the commitment date fair value of the shares.

This could be the case if the conversion price was out of the money at the commitment date as the computation prescribed by ASC 470-20-35-1 gives no consideration to this factor and assumes that the additional shares that will be received based on the adjusted conversion price all add additional intrinsic value rather than eliminate an out of the money deficit. Consider the following example that begins at ASC 470-20-55-23 and illustrates the computation outlined in ASC 470-20-35-1.

> Assume Entity A issues for $1 million a convertible debt instrument that is convertible into 100,000 shares of Entity A common stock ($10 conversion price) when the fair value of the stock is $10. This instrument provides that if Entity A subsequently issues common stock at a price less than $10, the conversion price adjusts to 90 percent of that subsequent issue price.
>
> If Entity A subsequently issues common stock at a price of $8 per share, the holder's conversion price adjusts to $7.20 ($8 × 90%) and the holder now would receive 138,888 shares ($1 million ÷ $7.20) upon conversion, an increase of 38,888 shares from the 100,000 shares that would have been received before the occurrence of the contingent event. The incremental intrinsic value that results from triggering the contingent option is $388,888—calculated as 38,888 shares × $10 stock price at the commitment date or, alternatively, ($1 million ÷ $7.20) × ($10 - $7.20)—and would be recognized upon the subsequent issuance of common stock at the $8 per share price. The accretion of this discount would be required from the date the common stock was subsequently issued at $8 per share in accordance with this Subtopic.

In this example, since the conversion price of $10 was at the money at the commitment date, the same conclusion was reached by multiplying the incremental shares by the commitment date stock price or by using the alternative computation (i.e., determining the number of shares that would be received upon conversion and multiplying that by the intrinsic value per share). If, however, in this example, the fair value of the stock was $9 at the commitment date rather than $10, the incremental intrinsic value computation would be $349,992 (38,888 shares x $9 stock price), and the actual intrinsic value would be $249,998 [138,888 x ($9 - $7.20)] — a difference of approximately $100,000 from the incremental intrinsic value computation. This difference is the amount by which the initial conversion feature was out of the money [100,000 initial shares to be received x ($10 - $9)]. We believe an acceptable accounting policy would be to compute the actual intrinsic value that is created based on the commitment date fair value rather than apply the guidance in ASC 470-20-35-1 literally.

3.4.2.2.1.1 Contingent adjustments that reduce the number of shares the holder will receive. If a contingent adjustment to the conversion price is triggered that decreases the number of shares the holder would receive rather than increases the number of shares, it is still necessary to remeasure the post-adjustment intrinsic value of the conversion option. In the event the amortized amount of discount on the convertible instrument that resulted from the initial, pre-adjustment measurement of the intrinsic value of the conversion option exceeds the remeasured post-adjustment intrinsic value of the conversion option, this excess amortization charge should not be reversed. However, remaining unamortized discount should be reversed through additional paid-in capital as necessary so that the sum of the amortized and unamortized discount equals the remeasured intrinsic value in accordance with ASC 470-20-55-16. This is illustrated in the example at Section 3.4.2.2.1.3.1 of this guide.

3.4.2.2.1.2 Conversion options that continuously reset. ASC 470-20-25-8 indicates that if a convertible instrument has a conversion option that continuously resets as the underlying stock price increases or decreases so as to provide a fixed value of common stock to the holder at any conversion date, the convertible instrument should be considered stock-settled debt. (See related discussion in Section 3.2 of this guide.) An example of this is when the conversion price is $1 million divided by the market price of the common stock on the date of conversion. If, however, the conversion price does not fully reset (e.g., it resets on specified dates before maturity), the reset would represent a contingent beneficial conversion feature.

3.4.2.2.1.3 Examples illustrating application of the guidance to contingent beneficial conversion features

3.4.2.2.1.3.1 Conversion price to be used to measure intrinsic value (from the example beginning at ASC 470-20-55-13)

Assume Entity A, a private entity, issues for $1 million a convertible instrument that is convertible 4 years after issuance at a conversion price of $10 per share (fair value of the stock is $10 at the commitment date). The instrument also contains a provision that the conversion price adjusts from $10 to $7 per share if Entity A does not have an initial public offering with a per-share price of $13 or more within 3 years. Entity B, a private entity, issues for $1 million a convertible instrument that is convertible 4 years after issuance at a conversion price of $7 per share (fair value of the stock is $10 at the commitment date). The instrument also contains a provision that the conversion price adjusts from $7 to $10 per share if Entity B successfully completes an initial public offering for a per-share price of $13 or more within 3 years.

The active conversion price for both Entity A and Entity B is $7, which is the conversion option price that would apply if there were no change in circumstances after the issuance date other than the passage of time. The intrinsic value of the conversion option of $428,571 [($1 million ÷ $7) × ($10 - $7)] should be recognized at the issuance date of the convertible instrument. If an event occurs that triggers a decrease in the number of shares to the holder upon conversion (the initial public offering in this Example), the intrinsic value of the adjusted conversion option should be recomputed using the commitment-date fair value of the underlying stock and the proceeds received for or allocated to the convertible instrument in the initial accounting.

If the amortized amount of discount on the convertible instrument resulting from the initial measurement of the intrinsic value of the conversion option before the adjustment exceeds the remeasured intrinsic value of the conversion option after the adjustment, the excess amortization charge should not be reversed. Any unamortized amount of that original discount amount that exceeds the amount necessary for the total discount (amortized and unamortized) to be equal to the intrinsic value of the adjusted conversion option should be reversed through a debit to paid-in capital (as an adjustment to the intrinsic value measurement of the conversion option). The adjusted unamortized discount, if any, should be amortized using the interest method pursuant to the recommended guidance in this Subtopic.

For example, assume in this Case that Entity A had an amortized discount of $85,714 and the remaining unamortized discount was $342,857 at the time it completed an initial public offering for a per-share price of more than $13. Entity A would remeasure the intrinsic value of the conversion option based on the adjusted conversion price of $10 per share and determine that there is no intrinsic value of the adjusted conversion option because the adjusted conversion price equals the fair value of the common stock at the initial commitment date. Entity A would reverse the entire $342,857 of remaining unamortized discount (credit) with an offsetting entry (debit) to additional paid-in capital. The $85,714 of discount previously amortized is not reversed.

3.4.2.2.1.3.2 Conversion price resets (from the example beginning at ASC 470-20-55-20)

Assume Entity A issues for $1 million a convertible debt instrument with a conversion option that allows the holder to convert the instrument at $12.50 per share for 80,000 shares of Entity A's common stock. The fair value of the common stock is $10 at the commitment date. The debt instrument also provides that if the market price of Entity A's common stock falls to $7 or less at any point during the conversion term, then the conversion price resets to $8.75 per share (the instrument would then become convertible into 114,286 shares).

A contingent beneficial conversion amount of $142,858 [($1 million ÷ $8.75) × ($10.00 - $8.75)] is required to be calculated at the commitment date but only recognized when and if Entity A's stock price falls to $7 or less. The accretion of this discount would be required from the date the stock price falls to $7 or less (regardless of the fact that the conversion price resets to $8.75 per share) in accordance with this Subtopic.

3.4.2.2.1.3.3 Instrument containing a fixed percentage conversion feature dependent on a future event (adapted from the example beginning at ASC 470-20-55-44)

Assumptions

a. $1,000,000 of convertible debt with a redemption date on the fifth anniversary of issuance

b. Convertible upon an IPO

c. Convertible at 80% of stock price at commitment date (that is, $40)

d. Fair value of common at commitment date equals $50 per share

Calculation

IPO price	$50	$60	$70
Stock price at commitment date	$50	$50	$50
80% of stock price at commitment date	$40	$40	$40
Intrinsic value of beneficial conversion feature at commitment date [All calculated using ($1,000,000 ÷ 40) x (50 - 40)]	$250,000	$250,000	$250,000

The instrument is not convertible at the commitment date; however, it will become convertible and that conversion feature will be beneficial if an IPO is completed. The intrinsic value of the beneficial conversion feature is calculated at the commitment date using the stock price as of that date, that is, $250,000. However, that amount only would be recorded at the date an IPO is completed. If the IPO were completed on the third anniversary of the debt issuance, the discount amount would be recorded at that date and amortized over a two-year period ending on the stated redemption date of the debt.

Entry at issuance

Cash	$1,000,000	
Debt		$1,000,000

Entry at IPO

Debt discount	$250,000	
Additional paid-in capital		$250,000

3.4.2.2.1.3.4 Convertible instrument containing fixed terms that change based on a future event (adapted from the example beginning at ASC 470-20-55-49)

Assumptions:

a. $1,000,000 of convertible debt with a redemption date on the fifth anniversary of issuance

b. Convertible at date of issuance

c. Convertible at 80% of stock price at commitment date (that is, $40)

d. Fair value of common at commitment date equals $50 per share

e. If there is an IPO, the conversion feature adjusts to the lesser of $30 or 80% of the IPO price

Calculation

Fair value at commitment date	$50
Conversion price at commitment date	$40
Intrinsic value of basic beneficial conversion feature at commitment date [(1,000,000 ÷ 40) x (50 – 40)]	$250,000
Conversion price at contingency resolution and intrinsic value of contingent beneficial conversion feature at commitment date	Unknown

This instrument includes a basic beneficial conversion feature that is not contingent upon the occurrence of a future event and a contingent beneficial conversion feature. Accordingly, the intrinsic value of the basic beneficial conversion feature of $250,000 is calculated at the commitment date and recorded at the issuance date. Because the debt has a stated redemption on the fifth anniversary of issuance, the debt discount should be amortized over a five-year period from the date of issuance to the stated redemption date.

Entry at date of issuance

Cash	$1,000,000	
Debt discount	250,000	
Debt		$1,000,000
Additional paid-in capital		250,000

The terms of the convertible debt instrument do not permit the number of shares that would be received upon conversion if an IPO occurs to be calculated at the commitment date.

3.4.2.2.2 Conversion feature terminates and instrument is redeemable at a premium. If a convertible debt instrument contains a conversion option that expires, with the instrument becoming redeemable at a premium at this expiration date, the beneficial conversion feature should be measured and recorded at the issuance date with the resulting discount accreted to the mandatory redemption amount. The following example from the guidance beginning at ASC 470-20-55-26 illustrates this.

Assume Entity A issues for $1 million a convertible debt instrument that is convertible by the holder 1 year from issuance into 120,000 shares of Entity A common stock (fair value of Entity A's common stock at the commitment date is $10). If the instrument is not converted at the end of 1 year, Entity A is required to redeem it for $1.2 million.

The debt instrument contains a beneficial conversion option with an intrinsic value of $200,000—that is, (120,000 shares × $10 per share) (which is equal to the fair value of stock to be received upon conversion) - $1 million (proceeds received). The total proceeds of $1 million are therefore allocated as follows: $800,000 to the convertible debt and $200,000 to the conversion option (recognized as additional paid-in capital). The debt is then accreted from $800,000 to the $1.2 million redemption amount over the 1-year period to the required redemption date in accordance with this Subtopic.

3.4.2.2.3 Interest forfeiture. If the terms of a convertible debt instrument provide that any accrued but unpaid interest at the date of conversion is forfeited, that interest should be accrued or imputed to the date of conversion in accordance with ASC 470-20-35-11.

3.4.2.3 Derecognition

3.4.2.3.1 Conversion pursuant to the contractual terms. When convertible debt is converted to equity securities pursuant to the original conversion terms, the net carrying amount of the debt (the face amount less any unamortized discount or issuance costs plus any premium or interest accrued to the date of conversion that will not be paid) generally should be credited to the appropriate liability or capital accounts (depending on the balance sheet classification of the conversion securities) in accordance with ASC 470-20-40-4. When an instrument for which a beneficial conversion feature was recognized in accordance with this guidance is converted, any remaining unamortized discount resulting from the beneficial conversion feature (or otherwise) should be recognized as interest expense in accordance with ASC 470-20-40-1. If interest that is not paid upon conversion (see earlier discussion on interest forfeiture) is not deductible for income tax purposes, any related tax benefit that may have been previously recognized should be charged to additional paid-in capital.

3.4.2.3.2 Induced conversion. For various reasons, issuers may decide to induce conversion of a convertible debt instrument by offering certain incentives to make conversion more attractive. An induced conversion, as defined and discussed in ASC 470-20-40-13 to 40-17, involves a situation whereby the conversion privileges in a convertible debt instrument are changed, or additional consideration is paid, to

debt holders for the purpose of inducing prompt conversion of the debt to equity securities. To be an induced conversion, the conversion must both:

a. Occur pursuant to changed conversion privileges that are exercisable only for a limited period of time

b. Include the issuance of all of the equity securities issuable pursuant to conversion privileges included in the terms of the debt at issuance, regardless of which party initiates the offer or whether the offer relates to all debt holders

The changed terms may involve the reduction of the original conversion price so that additional shares of stock are issued, the issuance of warrants or other securities not provided for in the original conversion terms, or the payment of cash or other consideration to those debt holders who convert during the specified limited period of time.

When both conditions specified above are met, the issuer should recognize an expense equal to the fair value of all securities and other consideration transferred in the transaction in excess of the fair value of securities issuable pursuant to the original conversion terms. The fair value of the securities and any other consideration should be measured as of the date the inducement offer is accepted. (This is normally the date the debt holder converts, or enters into a binding agreement to convert.)

The following example from ASC 470-20-55-3 to 55-5 illustrates this accounting. For simplicity, the face amount of each security is assumed to be equal to its carrying amount in the financial statements (i.e., no original issue premium or discount exists).

> On January 1, 19X4, Entity A issues a $1,000 face amount 10 percent convertible bond maturing December 31, 20X3. The carrying amount of the bond in the financial statements of Entity A is $1,000, and it is convertible into common shares of Entity A at a conversion price of $25 per share. On January 1, 19X6, the convertible bond has a fair value of $1,700. To induce convertible bondholders to convert their bonds promptly, Entity A reduces the conversion price to $20 for bondholders that convert before February 29, 19X6 (within 60 days).
>
> Assuming the market price of Entity A's common stock on the date of conversion is $40 per share, the fair value of the incremental consideration paid by Entity A upon conversion is calculated as follows for each $1,000 bond that is converted before February 29, 19X6.

Value of securities issued (a)	$2,000
Value of securities issuable pursuant to original conversion privileges (b)	1,600
Fair value of incremental consideration	$400

(a) Value of securities issued to debt holders is computed as follows:

Face amount	$1,000	
÷ New conversion price	÷ $20	per share
Number of common shares issued upon conversion	50	shares
× Price per common share	× $40	per share
Value of securities issued	$2,000	

(b) Value of securities issuable pursuant to original conversion privileges is computed as follows:

Face amount	$1,000	
÷ Original conversion price	÷ $25	per share
Number of common shares issuable pursuant to original conversion privileges	40	shares
× Price per common share	× $40	per share
Value of securities issuable pursuant to original conversion privileges	$1,600	

Therefore, Entity A records debt conversion expense equal to the fair value of the incremental consideration paid as follows.

	Debit	Credit
Convertible debt	$1,000	
Debt conversion expense	400	
Common stock		$1,400

3.4.2.3.3 Instrument became convertible due to the issuer's exercise of a call option. If an instrument becomes convertible due to the issuer's exercise of a call option and the conversion option is considered to be nonsubstantive as of the instrument's issuance date, the conversion would be accounted for as a debt extinguishment. If the conversion feature is deemed to be substantive as of its issuance date, the conversion is accounted for as a conversion; that is, there is no gain or loss recognized related to the equity securities issued to settle the instrument. By definition, a substantive conversion feature is at least reasonably possible of being exercised in the future. Instruments with extremely high conversion prices at the issuance date or that only become convertible if the issuer exercises a call option generally are considered to have conversion features that are not substantive. ASC 470-20-40-9 provides additional guidance to be used in making this determination.

3.4.2.3.4 Modifications or extinguishments. Refer to Section 3.4.4.1 for a discussion of modification and extinguishment considerations related to convertible debt instruments in general. If the determination is made that a debt instrument for which a beneficial conversion feature had been recognized is extinguished, it is necessary to allocate to the beneficial conversion feature a portion of the reacquisition price equal to the intrinsic value of the conversion feature at the extinguishment date. The residual amount of the reacquisition price, if any, is allocated to the convertible debt instrument, and a gain or loss on extinguishment is recognized. An example adapted from ASC 470-20-55-61 follows.

At the commitment date

Proceeds from issuance of zero-coupon convertible debt	$100
Intrinsic value of beneficial conversion feature	$90

At the commitment date, the issuer records $90 as discount on the debt, with the offsetting entry to additional paid-in capital. The remainder ($10) is recorded as debt and is accreted to its full face value of $100 over the period from the issuance date to the stated redemption date of the instrument (three years). The debt subsequently is extinguished one year after issuance.

At the extinguishment date

Reacquisition price	$150
Intrinsic value of beneficial conversion feature at extinguishment	$80
Carrying value of debt (The net carrying value of the debt one year after issuance is calculated using the effective interest method to amortize the debt discount over three years.)	$22

At the date of extinguishment, the extinguishment proceeds first should be allocated to the beneficial conversion feature ($80 as noted in the preceding table). The remainder ($70) is allocated to the extinguishment of the convertible security.

Entry to record the extinguishment

Debt	$22	
Equity (paid-in capital)	80	
Loss on extinguishment	48	
Cash		$150

3.4.3 Convertible debt instruments issued at a substantial premium – Before adoption of ASU 2020-06

ASC 470-20-25-13 provides that, if a convertible debt instrument is issued at a substantial premium, there is a presumption that the premium represents additional paid-in capital. We believe this should be considered only after determining that derivative recognition is not necessary for the conversion option and after considering the matters in Section 3.4.1 and Section 3.4.2 of this guide to determine whether a portion of the debt should be recognized as equity. The intent of ASC 470-20-25-13 is somewhat of a catch all in that if, after considering the other guidance, you are left with a convertible instrument that is issued at an initial carrying amount that is significantly greater than its face, that premium should be recognized in its entirety as additional paid-in capital in accordance with ASC 470-20-25-13. A circumstance we have observed in practice relates to modifications of convertible instruments that result in extinguishment accounting under ASC 470-50 whereby the modified debt instruments are required to be measured at fair value. As a result of the conversion feature being in the money at the fair value measurement date, the instruments had a fair value that was significantly in excess of the face amount. When applying the beneficial conversion feature guidance in ASC 470-20 discussed in Section 3.4.2 of this guide, there generally is not any intrinsic value associated with a conversion feature in a convertible instrument that has been newly remeasured at fair value, given that the proceeds (fair value of the instrument) would be expected to equal or exceed the value of the shares into which the instrument could be converted. An example follows.

Example: Convertible debt issued at a substantial premium

A convertible debt instrument with a face amount of $10 million is recorded at its fair value on June 15, 20XX as a result of a debt extinguishment. The fair value of the debt is determined in accordance with ASC 820 and estimated to be $15 million, a premium of $5 million or 50 percent. This premium is primarily attributable to the fact that the conversion feature is significantly in the money at the valuation date, given that the value of the shares into which the instrument can be converted was $13 million at that time. Because the proceeds attributable to the instrument (fair value of $15 million) exceed the value of the conversion shares, there is no beneficial conversion feature to be recognized in accordance with the guidance in Section 2.4.2 of this guide; however, given that the premium is substantial and attributable in part to the conversion feature being in the money, we believe it would be appropriate to record the full $5 million premium as additional paid-in capital.

Substantial premium is not defined; however, in practice, some have referred to ASC 470-50-40-10, which uses a threshold of 10 percent or more change in the present value of cash flows, in determining whether a modified instrument is substantially different. Applying this guidance by analogy, a premium of 10 percent or more (measured after allocation of proceeds to other instruments if warranted) would be considered to be substantial. We have observed instances whereby, without the recognition of the premium as additional paid-in capital, the accretion of the premium would more than offset the contractual interest expense, resulting in negative interest expense recognition on the debt instrument. Circumstances such as this may warrant recognition of the premium as additional paid-in capital regardless of the percentage size of the premium.

3.4.4 Accounting treatment if no separate recognition is necessary for conversion feature – Before adoption of ASU 2020-06

If it is determined that no separate recognition is necessary for the conversion feature, the instrument is basically accounted for in the same manner as nonconvertible instruments. When convertible debt is converted to equity securities pursuant to the original conversion terms, the net carrying amount of the debt (the face amount less any unamortized discount or issuance costs plus any premium or interest accrued to the date of conversion that will not be paid) should be credited to the appropriate liability or capital accounts (depending on the balance sheet classification of the conversion securities) in

accordance with ASC 470-20-40-4. If interest that is not paid upon conversion (see the earlier discussion on interest forfeiture) is not deductible for income tax purposes, any related tax benefit that previously may have been recognized should be charged to additional paid-in capital. The guidance in preceding sections of this guide addresses conversion when the conversion feature was given separate recognition as a derivative (Section 3.3.3.1), a cash conversion feature (Section 3.4.1.3) or a beneficial conversion feature (Section 3.4.2.3).

3.4.4.1 Modifications or extinguishments

ASC 470-50 includes guidance specific to convertible debt in the context of modifications and extinguishments. As pointed out in ASC 470-50-15, this guidance does not apply to induced conversions or to conversions that occur in accordance with the contractual terms; however, it does apply to modifications of convertible debt and to extinguishments effected by issuing stock that does not represent the exercise of a conversion right included in the terms of the debt at issuance. Pertinent excerpts from ASC 470-50-40 include:

- ASC 470-50-40-5 indicates that, if debt issued with warrants is permitted to be tendered toward the exercise price of the warrants, any such tendering would be accounted for in the same manner as a conversion rather than as an extinguishment.
- ASC 470-50-40-10 to 40-12 includes guidance on determining how modifications to an embedded conversion option, or the addition or elimination of a conversion option, should be considered in determining whether a modified debt instrument is substantially different.
- ASC 470-50-40-14 and 40-15 address how a change in the fair value of a conversion option should be accounted for if a modification occurs.
- ASC 470-50-40-16 indicates that a beneficial conversion feature should not be recognized or reassessed upon a modification or exchange that is not accounted for as an extinguishment. While reassessment is appropriate for modified instruments that are subject to extinguishment accounting, such instruments typically would not include a beneficial conversion feature, given that the modified instrument would be recorded at its fair value, which would likely incorporate the intrinsic value associated with any noncontingent conversion feature. However, in this circumstance, if the fair value constitutes a significant premium to the face amount, it may be appropriate to recognize the premium as additional paid-in capital. (Refer to Section 3.4.3 of this guide.)

The guidance in preceding sections addresses modifications and extinguishments when the conversion feature was given separate recognition as a derivative (Section 3.3.3.1.2), a cash conversion feature (Section 3.4.1.3) or a beneficial conversion feature (Section 3.4.2.3). For additional guidance, refer also to our debt modifications and restructurings guide.

3.5 Amortizing discounts on debt or redeemable preferred stock – Before adoption of ASU 2020-06

ASC 835-30 requires the use of the interest method, which is defined as “the method used to arrive at a periodic interest cost (including amortization) that will represent a level effective rate on the sum of the face amount of the debt and (plus or minus) the unamortized premium or discount and expense at the beginning of each period.” The use of a straight-line or other simplified approach for amortizing discounts can significantly distort the results, particularly when, as a result of allocating proceeds to other instruments, the initial carrying amount of the debt or redeemable stock is significantly less than the face amount.

The next two pages of this guide include an example illustrating this in the context of a non-amortizing debt instrument with a face amount of $5 million. In this example, the initial net carrying amount of the debt is $2 million, given that proceeds of $3 million were allocated to warrants, creating a discount on the debt. As is illustrated through this example, the use of the straight-line method rather than the interest

method results in an overstatement of interest expense of $454,898 in the first year that reverses in the second year. The computation would be similar for redeemable stock; however, dividends (rather than interest expense) would be recognized if the redeemable stock is accounted for as equity or temporary equity.

					Interest method	
	A	B (Note 1)	C = A – B	D (Note 2)	E = F – D	F (Note 3)
Date	Principal	Unamortized discount	Net carrying amount	Contractual interest (10%)	Amortization	Total interest
1/1/20X4	$5,000,000	($3,000,000)	$2,000,000			
1/31/20X4	5,000,000	(2,936,193)	2,063,807	$41,096	$63,807	$104,903
2/28/20X4	5,000,000	(2,873,516)	2,126,484	38,356	62,677	101,033
3/31/20X4	5,000,000	(2,800,727)	2,199,273	42,466	72,789	115,255
4/30/20X4	5,000,000	(2,726,468)	2,273,532	41,096	74,259	115,355
5/31/20X4	5,000,000	(2,645,709)	2,354,291	42,466	80,759	123,225
6/30/20X4	5,000,000	(2,563,319)	2,436,681	41,096	82,390	123,486
7/31/20X4	5,000,000	(2,473,717)	2,526,283	42,466	89,602	132,068
8/31/20X4	5,000,000	(2,379,259)	2,620,741	42,466	94,458	136,924
9/30/20X4	5,000,000	(2,282,893)	2,717,107	41,096	96,366	137,462
10/31/20X4	5,000,000	(2,178,092)	2,821,908	42,466	104,801	147,267
11/30/20X4	5,000,000	(2,071,175)	2,928,825	41,096	106,917	148,013
12/31/20X4	5,000,000	(1,954,899)	3,045,101	42,466	116,276	158,742
Subtotal						1,543,733
1/31/20X5	5,000,000	(1,832,321)	3,167,679	42,466	122,578	165,044
2/28/20X5	5,000,000	(1,715,604)	3,284,396	38,356	116,717	155,073
3/31/20X5	5,000,000	(1,580,056)	3,419,944	42,466	135,548	178,014
4/30/20X5	5,000,000	(1,441,771)	3,558,229	41,096	138,285	179,381
5/31/20X5	5,000,000	(1,291,381)	3,708,619	42,466	150,390	192,856
6/30/20X5	5,000,000	(1,137,954)	3,862,046	41,096	153,427	194,523
7/31/20X5	5,000,000	(971,098)	4,028,902	42,466	166,856	209,322
8/31/20X5	5,000,000	(795,198)	4,204,802	42,466	175,900	218,366
9/30/20X5	5,000,000	(615,746)	4,384,254	41,096	179,452	220,548
10/31/20X5	5,000,000	(420,586)	4,579,414	42,466	195,160	237,626
11/30/20X5	5,000,000	(221,485)	4,778,515	41,096	199,101	240,197
12/31/20X5	-	-	-	42,466	221,485	263,951
Subtotal						2,454,901
Total				$998,634	$3,000,000	$3,998,634

Note 1: Unamortized discount is computed by reducing the previous month's unamortized discount balance by the current month's amortization.

Note 2: Contractual interest is computed by multiplying the outstanding principal balance at the beginning of the month by 10 percent, dividing that result by 365 days and multiplying that result by the number of days in the month for which interest is payable.

Note 3: Total interest is computed by multiplying the net carrying amount at the beginning of the month by the effective interest rate (63.816 percent), dividing that result by 365 days and multiplying that result by the number of days in the month. (The effective interest rate was determined by solving for the rate that equates the present value of the future cash outflows to the initial net carrying amount of $2 million.) In addition, total interest for December 20X5 includes an additional $4,956 for balancing purposes due to rounding.

Date	Principal	A (Note 1)	Straight-line method		Interest method	Difference
			B (Note 2)	A + B		
		Contractual interest (10%)	Amortization	Total interest	Total interest	
1/1/20X4	$5,000,000					
1/31/20X4	5,000,000	$41,096	$127,397	$168,493		
2/28/20X4	5,000,000	38,356	115,068	153,424		
3/31/20X4	5,000,000	42,466	127,397	169,863		
4/30/20X4	5,000,000	41,096	123,288	164,384		
5/31/20X4	5,000,000	42,466	127,397	169,863		
6/30/20X4	5,000,000	41,096	123,288	164,384		
7/31/20X4	5,000,000	42,466	127,397	169,863		
8/31/20X4	5,000,000	42,466	127,397	169,863		
9/30/20X4	5,000,000	41,096	123,288	164,384		
10/31/20X4	5,000,000	42,466	127,397	169,863		
11/30/20X4	5,000,000	41,096	123,288	164,384		
12/31/20X4	5,000,000	42,466	127,397	169,863		
Subtotal				1,998,631	$1,543,733	$454,898
1/31/20X5	5,000,000	42,466	127,397	169,863		
2/28/20X5	5,000,000	38,356	115,068	153,424		
3/31/20X5	5,000,000	42,466	127,397	169,863		
4/30/20X5	5,000,000	41,096	123,288	164,384		
5/31/20X5	5,000,000	42,466	127,397	169,863		
6/30/20X5	5,000,000	41,096	123,288	164,384		
7/31/20X5	5,000,000	42,466	127,397	169,863		
8/31/20X5	5,000,000	42,466	127,397	169,863		
9/30/20X5	5,000,000	41,096	123,288	164,384		
10/31/20X5	5,000,000	42,466	127,397	169,863		
11/30/20X5	5,000,000	41,096	123,289	164,385		
12/31/20X5	-	42,466	127,398	169,864		
Subtotal				2,000,003	2,454,901	(454,898)
Total		$998,634	$3,000,000	$3,998,634	$3,998,634	$ -

Note 1: Contractual interest is computed by multiplying the outstanding principal balance at the beginning of the month by 10 percent, dividing that result by 365 days and multiplying that result by the number of days in the month for which is interest is payable.

Note 2: Amortization is computed by dividing the total discount of $3 million by the number of days in the term of the debt (730) and multiplying that result by the number of days in the month.

Exhibit: High-level overview of the accounting for a convertible instrument

The following chart provides a high-level overview of the accounting for a convertible instrument when (a) the conversion feature is required to be separately recognized as either (i) a derivative in accordance with ASC 815, (ii) a cash conversion feature in accordance with ASC 470-20 or (iii) a beneficial conversion feature in accordance with ASC 470-20 and (b) the conversion feature is not required to be separately recognized. Sections of this chapter of the guide are referenced in the chart and should be considered, together with the applicable authoritative guidance, to supplement this overview.

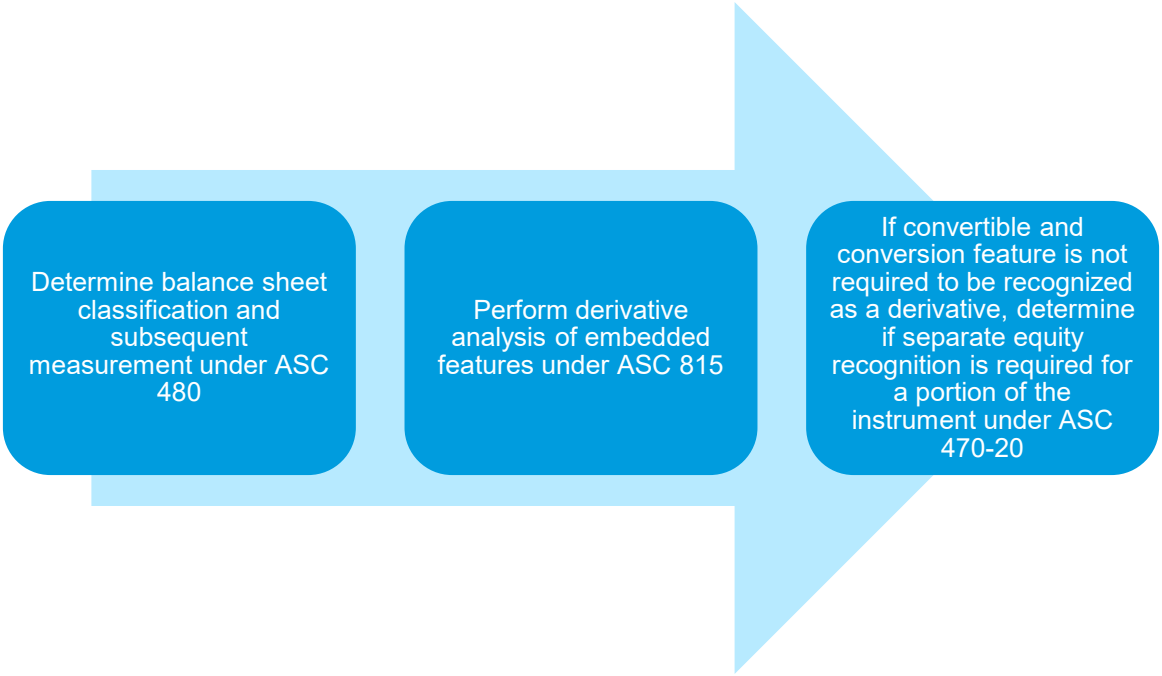
	Derivative (Section 3.3)	**Cash conversion feature (Section 3.4.1)**	**Beneficial conversion feature (Section 3.4.2)**	**No separate recognition (Section 3.4.4)**
Balance sheet classification and initial measurement of the conversion option	Conversion option is accounted for as a liability at fair value (Section 3.3.3).	A portion of the proceeds is recognized in equity, determined as the residual of the proceeds over the fair value of a similar liability without a conversion feature (Section 3.4.1.1).	A portion of the proceeds equal to the intrinsic value is recognized in equity (Section 3.4.2.1).	N/A (The conversion option is not separately recognized.)
Subsequent measurement considerations	The conversion option is subsequently measured at fair value, with changes in fair value recognized in earnings (Section 3.3.3).	The amount in equity is not subsequently adjusted (Section 3.4.1.2).	The amount in equity is not subsequently adjusted (Section 3.4.2.2).	N/A
	Amortize the discount on the debt and the issuance costs using the interest method (Section 3.5) and consider the following specific guidance:			
	None	Section 3.4.1.2	Section 3.4.2.2	None
Ongoing reminders (in part)	Reassess whether derivative conclusions remain appropriate (Section 3.3.5)			
	Recognize additional derivative amounts as appropriate if interest accrues and is convertible	None	Account for contingent conversion options and conversion prices that reset in accordance with Section 3.4.2.2.1,	Account for contingent conversion options and conversion prices that reset in accordance with Section 3.4.2.2.1,

	Derivative (Section 3.3)	Cash conversion feature (Section 3.4.1)	Beneficial conversion feature (Section 3.4.2)	No separate recognition (Section 3.4.4)
			and beneficial conversion features on interest that is paid in kind in accordance with Section 3.4.2.1.4	and beneficial conversion features on interest that is paid in kind in accordance with Section 3.4.2.1.4
Accounting upon conversion	Account for as an extinguishment in accordance with ASC 470-50 and Section 3.3.3.1.1	Derecognize in accordance with Section 3.4.1.3 and Section 3.4.1.3.2 if relevant	Account for as a conversion in accordance with Section 3.4.2.3.1, 3.4.2.3.2 or 3.4.2.3.3 as relevant	Account for as a conversion in accordance with Section 3.4.4 or Section 3.4.2.3.2
Accounting upon modification	Consider and apply ASC 470-50 or ASC 470-60, as appropriate. (For additional guidance, refer to our debt modifications and restructurings guide.) Reassess conclusions reached on the accounting for any conversion features and other potential derivatives in light of the modifications. Consider the following specific guidance:			
	Section 3.3.3.1.2	Section 3.4.1.3.1	Section 3.4.4.1	None
Accounting upon extinguishment	Apply extinguishment accounting in accordance with ASC 470-50 and Section 3.3.3.1	Derecognize in accordance with Section 3.4.1.3	Apply extinguishment accounting in accordance with ASC 470-50 and Section 3.4.2.3.4	Apply extinguishment accounting in accordance with ASC 470-50

Chapter 4: Accounting for preferred and similar stock

4.1 Introduction

Accounting for preferred and similar stock can be complex given the need to determine (a) the appropriate balance sheet classification and resultant subsequent measurement under ASC 480, (b) whether any feature embedded in the preferred stock instrument needs to be separately recognized as a derivative under ASC 815, and (c) prior to adoption of ASU 2020-06, for convertible preferred stock for which the conversion feature does not require derivative accounting, whether a portion of the preferred stock instrument needs to be recognized as a separate component of equity under ASC 470-20.



Each of these three steps is discussed in Sections 4.2 to 4.4 of this chapter. This chapter also addresses the accounting for (a) down round features, conversions, modifications and redemptions in Section 4.5, (b) delayed issuances of preferred or other stock in Section 4.6 and (c) dividends on preferred stock in Section 4.7. Lastly, the exhibit at the end of this chapter contains a high-level overview of the accounting for convertible preferred stock when (a) the conversion feature is required to be separately recognized as a derivative in accordance with ASC 815 or, prior to adoption of ASU 2020-06, a beneficial conversion feature in accordance with ASC 470-20 and (b) the conversion feature is not required to be separately recognized.

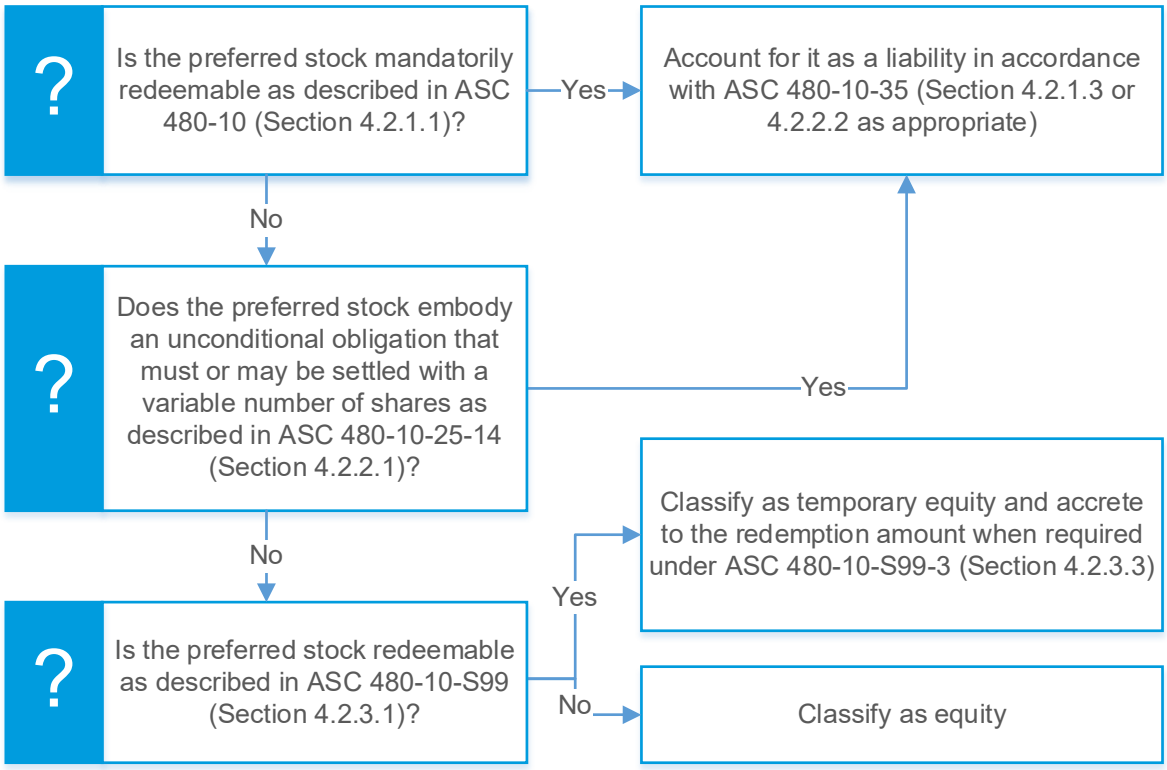
Refer to Appendix C for additional information regarding ASU 2020-06.

While the focus of this chapter is preferred stock, for the most part, the discussion applies to any stock issued by an entity that has features that are not found in typical common stock, including stated dividends, conversion options and provisions for redemption, regardless of the label.

4.2 Balance sheet classification and subsequent measurement

The first step in accounting for preferred stock is to determine its proper balance sheet classification by considering the guidance within ASC 480. Depending on its characteristics, preferred stock may need to be classified as debt, equity or temporary equity (also referred to as mezzanine capital). ASC 480-10 requires liability treatment for certain mandatorily redeemable stock as well as certain preferred or other instruments in the form of a share that embody an unconditional obligation that the issuer must or may

settle in a variable number of its equity shares. SEC staff guidance is also included within ASC 480-10-S99 to address when temporary equity presentation is required. This thought process is summarized in the following flowchart and discussed in more depth in referenced sections that follow.



4.2.1 Mandatorily redeemable stock

4.2.1.1 Determining if a stock is mandatorily redeemable

ASC 480-10-25-4 requires liability treatment for certain mandatorily redeemable financial instruments.

Understanding the terminology

The Master Glossary of ASC defines a mandatorily redeemable financial instrument as "Any of various financial instruments issued in the form of shares that embody an unconditional obligation requiring the issuer to redeem the instrument by transferring its assets at a specified or determinable date (or dates) or upon an event that is certain to occur."

It is important to note that if an entity issues preferred shares that are redeemable at either party's option or upon the occurrence of a contingent event that is not certain to occur, the shares are not within the scope of ASC 480 because there is no unconditional obligation. In other words, redemption is not mandatory given it is subject to a party electing to exercise the redemption option or a contingent event occurring.

In determining if an instrument is mandatorily redeemable, consideration should also be given to the following:

- As is pointed out at ASC 480-10-25-4, if redemption is required to occur only upon the liquidation or termination of the reporting entity, the instrument *would not be* considered mandatorily redeemable in that entity's standalone financial statements. However, it would be considered mandatorily

redeemable in the consolidated financial statements if redemption is required to occur before the liquidation or termination of the reporting entity.

- If redemption is to occur upon the death or termination of the holder, the instrument *would be* considered mandatorily redeemable in accordance with ASC 480-10-55-4.
- As is pointed out at ASC 480-10-25-6, term extension options, provisions that defer redemption until a specified liquidity level is reached or similar provisions that may delay or accelerate the timing of a mandatory redemption *do not affect* the classification of a mandatorily redeemable financial instrument as a liability.
- In accordance with ASC 480-10-55-11, redeemable instruments that are convertible into common shares *are generally not considered* to be mandatorily redeemable during the period of time they are convertible because redemption is conditional upon the holder not electing to convert. As noted in the next bullet point, if the conversion option is nonsubstantive (e.g., the conversion price is extremely high in relation to the current share price), it would be disregarded.
- As is pointed out at ASC 480-10-55-12, nonsubstantive or minimal features *are disregarded*
- There can be a *continuous need for reassessment* as instruments that are conditionally redeemable upon an event not certain to occur become mandatorily redeemable if the event occurs, the condition is resolved or the event becomes certain to occur in accordance with ASC 480-10-25-5.

The following examples adapted from ASC 480-10-55-10 to 55-12 serve to illustrate these concepts.

Example: Conditionally redeemable shares become mandatorily redeemable

> An entity issues equity shares on January 20, 20X4, that must be redeemed (i.e., not at the option of the holder) six months after a change in control. When issued, the shares are conditionally redeemable and, therefore, do not meet the definition of mandatorily redeemable. On December 30, 20X8, there is a change in control, requiring the shares to be redeemed on June 30, 20X9. On December 31, 20X8, the entity treats the shares as mandatorily redeemable and reclassifies the shares as liabilities, measured initially at fair value. Additionally, the entity reduces equity by the amount of that initial measurement, recognizing no gain or loss.

Example: Convertible, redeemable shares

> An entity issues preferred shares with a stated redemption date 30 years hence that are convertible at the option of the holders into a fixed number of common shares during the first ten years. Those instruments are not mandatorily redeemable for the first ten years because the redemption is conditional (i.e., contingent upon the holder's not exercising its option to convert the preferred shares into common shares). If the conversion option was not substantive at issuance (e.g., the conversion price is extremely high in relation to the current share price), it would be disregarded in which case the preferred shares would be considered mandatorily redeemable and classified as liabilities with no subsequent reassessment of the nonsubstantive feature.

4.2.1.2 Application to private companies

ASC 480 provides a scope exception that excludes mandatorily redeemable stock issued by nonpublic entities that are not SEC registrants from the liability classification, measurement and disclosure guidance in ASC 480 unless the stock is mandatorily redeemable on fixed dates for amounts that are either fixed or are determined by reference to an external index. An example of a mandatorily redeemable instrument that would not be subject to the scope exception is an instrument that is required to be redeemed on a stated date for the original issue price plus a stated rate of dividends or a variable rate of dividends based on changes in an interest rate index. Examples of instruments that would qualify for the scope exception include those instruments that are required to be redeemed at the greater of: (a) the original issuance price or (b) fair value (or book value) at the time of redemption, given that the redemption amount is not fixed or determined by reference to an external index.

For purposes of the scope exception, an SEC registrant is defined as an entity (or an entity that is controlled by an entity) that either (a) has issued or will issue debt or equity securities that are traded in a public market (domestic or foreign stock exchange or an over-the-counter market), (b) is required to file financial statements with the SEC or (c) provides financial statements for the purpose of issuing any class of securities in a public market.

4.2.1.3 Initial and subsequent measurement

If the preferred stock is required to be accounted for as a mandatorily redeemable instrument, it is measured initially at fair value (generally, the proceeds for which it was issued, or its allocated share of proceeds if it was issued with other freestanding financial instruments). For each subsequent reporting period, ASC 480-10-35-3 provides that the instrument is measured in one of the following two ways:

- If both the amount to be paid and the settlement date are fixed, the instrument is subsequently measured at the present value of the amount to be paid at settlement, accruing interest cost using the interest rate implicit at inception.
- If either the amount to be paid or the settlement date varies based on specified conditions, the instrument is subsequently measured at the amount of cash that would be paid under the condition specified in the contract if settlement occurred at the reporting date, recognizing the resulting change in that amount from the previous reporting date as interest cost.

ASC 480-10-30-2 addresses the accounting for a conditionally redeemable instrument that becomes mandatorily redeemable and indicates that the instrument's fair value at that time would be reclassified from equity to a liability, with no gain or loss recognized. (Paid in capital would be adjusted to the extent the fair value of the liability differs from the carrying amount of the preferred instrument.) The instrument is subsequently measured in accordance with the preceding paragraph.

4.2.2 Obligations to issue a variable number of shares

4.2.2.1 Determining if the stock embodies an obligation to issue a variable number of shares

A financial instrument such as preferred stock that is in the form of an outstanding share requires liability treatment under ASC 480-10-25-14 if it embodies an unconditional obligation that the issuer must or may settle by issuing a variable number of its equity shares if, at inception, the monetary value of the obligation is based solely or predominantly on any one of the following criteria (referred to for the remainder of this section as the three criteria):

1. A fixed monetary amount known at inception (e.g., a payable settled with the number of issuer's equity shares required to equate to a fixed amount of value)
2. Variations in something other than the fair value of the issuer's equity shares (e.g., a financial instrument indexed to the Standard & Poor's 500 index and settled with a variable number of the issuer's equity shares)
3. Variations inversely related to changes in the fair value of the issuer's equity shares (e.g., a written put option that could be net share settled)

Understanding the terminology

The following are key terms used in ASC 480-10, along with their definitions from the Master Glossary of the ASC:

- **Monetary value:** "What the fair value of the cash, shares, or other instruments that a financial instrument obligates the issuer to convey to the holder would be at the settlement date under specified market conditions."

- **Obligation:** "A conditional or unconditional duty or responsibility to transfer assets or to issue equity shares."

While it is not uncommon for preferred stock instruments to have conversion or other features that could result in the issuance of a variable number of shares, the obligation that may result in settlement in a variable number of shares needs to be unconditional and the monetary value of the obligation needs to be based solely or predominantly on one of the three criteria listed earlier. The preferred stock we have observed in practice rarely meets these requirements. However, on occasion, we have observed instruments that are required to be settled for a fixed monetary amount payable in a variable number of shares. Two examples follow.

Example: Preferred stock requires conversion into shares worth a stated value

An entity issues preferred stock for $1,000 that unconditionally requires conversion into common shares worth $1,100 on the stated conversion date. In this situation, the number of common shares that are required to be issued varies based on the fair value of those shares at the conversion date. Regardless of changes in the fair value of the common shares, the holder will receive $1,100 of value.

Example: Preferred stock must be redeemed for cash or settled in shares (adapted from ASC 480-10-55-28)

> An entity issues preferred stock for cash equal to the stock's liquidation preference of $25 per share. The entity is required either to redeem the shares on the fifth anniversary of issuance for the issuance price or to settle by issuing sufficient shares of its common stock to be worth $25 per share. This obligation does not represent an unconditional obligation to transfer assets, and therefore, is not a mandatorily redeemable financial instrument. However, it is still a liability under ASC 480 because the preferred shares embody an unconditional obligation that the issuer may settle by issuing a variable number of its equity shares with a monetary value that is fixed and known at inception.

The analysis becomes more complex when the monetary value ($1,100 in the first of the two immediately preceding examples and $25 in in the second of the two examples) is not solely based on one of the three criteria, but rather is in part based on one of these criteria. Subjectivity comes into play in determining if the monetary value is based predominantly on one of these criteria because predominantly is not defined in ASC 480. Certain examples in ASC 480-10-55 touch on this, including ASC 480-10-55-22. In the context of the two immediately preceding examples, if the number of common shares to be issued is determined based on an average share value over a stated period of time (e.g., 30 days before settlement), rather than the fair value of the shares at settlement, based on the example at ASC 480-10-55-22, a conclusion would be reached that while the monetary value is in small part based on variations in the fair value of the shares that can occur during the 30 day period, the monetary value is predominantly fixed. We are aware of divergent views in practice as to whether predominant should be interpreted as more likely than not or a higher threshold (e.g., 90 percent) as suggested by the use of the words "in small part" in ASC 480-10-55-22. If the instrument does embody an unconditional obligation that the issuer must or may settle in a variable number of its shares, and at issuance the monetary value is based solely or predominantly on one of the three criteria, the instrument should be accounted for as a liability. If not, the feature that could result in the issuance of a variable number of shares is evaluated to determine if it should be separately recognized as a derivative as discussed in Section 4.3.

4.2.2.2 Initial and subsequent measurement

ASC 480-10-30 provides for the initial measurement of instruments within the scope to be fair value, which is generally the issuance price. As indicated at ASC 480-10-35-5, financial instruments recognized as a liability based on the guidance applicable to obligations to issue a variable number of shares are generally subsequently measured at fair value with changes in fair value recognized in earnings unless ASC 480 or another topic provides otherwise. Those instruments in the examples at Section 4.2.2.1 that

will be settled for a monetary value that is fixed are generally accounted for as stock-settled debt and accreted or amortized (as applicable) to the fixed settlement amount through interest expense in accordance with the interest method (illustrated in Section 2.6 and Section 3.5, as applicable).

4.2.3 Temporary equity presentation of redeemable stock

4.2.3.1 Determining if the stock is redeemable

The guidance in ASC 480-10-S99, which was issued by the SEC staff, provides that redeemable stock that is not required to be accounted for as a liability should be reported in temporary equity rather than permanent equity and accreted to its redemption amount as elaborated on herein. While technically this guidance only applies to SEC registrants, we believe it is preferable for private companies to follow this guidance.

Redeemable stock for the purpose of this guidance is defined in ASC 480-10-S99-3A to include any type of equity security that has any of the following characteristics:

- It is redeemable at a fixed or determinable price on a fixed or determinable date or dates.
- It is redeemable at the option of the holder.
- It has any condition for redemption that is not solely within the control of the issuer without regard to probability.

Careful consideration should be given to all circumstances that could permit or require the issuer to redeem the stock. To illustrate, even an equity instrument that can be redeemed at the option of the issuer (i.e., is callable) could require temporary equity classification because, for example, the holders of the class of shares control the board of directors or have majority voting rights such that they are effectively making the decision as to whether the call option is exercised.

Ordinary liquidation provisions that provide for the redemption and liquidation of all of an entity's equity instruments through the distribution of net assets upon the final liquidation or termination of the entity do not result in classification as redeemable stock. However, further consideration needs to be given to provisions that may require redemption upon the occurrence of deemed liquidation events that do not result in the liquidation or termination of the issuing entity. Deemed liquidation events may include events such as a change in control, delisting of the issuer's securities from an exchange or the violation of a debt covenant. If the issuer would or could be required to redeem one or more particular classes of equity for cash or other assets upon the occurrence of a deemed liquidation event, those instruments would be considered to be redeemable stock unless all of the holders of equally and more subordinated equity instruments of the issuer would always be entitled to also receive the same form of consideration (e.g., cash or shares) upon the occurrence of the event. Determining whether an equity instrument is redeemable at the option of the holder or upon the occurrence of an event that is solely within the control of the issuer can be complex. Accordingly, all of the individual facts and circumstances surrounding events that could trigger redemption should be evaluated. For convertible instruments, this includes considering whether the issuer can control share settlement of the conversion option, with consideration given to the guidance in ASC 815-40-25, because otherwise, redemption of the instrument would be presumed. The possibility that any triggering event that is not solely within the control of the issuer could occur (without regard to probability) requires the instrument to be considered redeemable stock.

Interaction with ASU 2020-06

Upon adoption of ASU 2020-06, an entity is not required to consider the following conditions in ASC 815-40-25 when determining whether share settlement is within its control, except as described below:

- Settlement is permitted in unregistered shares. As amended by ASU 2020-06, a requirement to settle in registered shares would not preclude equity classification unless the contract explicitly

states that an entity must settle the instrument or feature in cash if registered shares are unavailable.

- There are no counterparty rights that rank higher than shareholder rights. Even if the instrument or feature provides the counterparty with rights that rank higher than those of the holder of the underlying shares, equity classification would not be precluded.
- There is no collateral required. Equity classification would not be precluded if the contract includes a requirement to post collateral.

While ASU 2020-06 eliminates these three conditions such that cash settlement is no longer presumed in such circumstances under ASC 815-40-25, corresponding changes have not been made to the SEC guidance in ASC 480-10-S99 on temporary equity classification. Specifically, there is some uncertainty around how the changes to ASC 815-40 impact the application of the SEC guidance in ASC 480-10-S99-3A in determining whether instruments that meet the requirements in ASC 815-40 for equity treatment should be classified as temporary or permanent equity in light of the scope of this SEC guidance and the requirement in ASC 480-10-S99-3A(6) to consider the guidance in ASC 815-40-25 when determining whether an issuer can control share settlement. Based on informal discussions with the SEC staff, the references in ASC 480-10-S99-3A are to the legacy guidance in ASC 815-40-25 (i.e., guidance in place prior to ASU 2020-06). Entities are encouraged to carefully consider these nuances and monitor future developments.

4.2.3.1.1 Examples in which temporary equity classification is appropriate. The following examples from ASC 480-10-S99-3A are useful in understanding under what circumstances instruments are considered to be redeemable such that temporary equity classification is appropriate. These examples are followed by others in ASC 480-10-S99-3A demonstrating when permanent equity classification is appropriate.

Example 1. A preferred security that is not required to be classified as a liability under other applicable GAAP may be redeemable at the option of the holder or upon the occurrence of an event that is not solely within the control of the issuer. Upon redemption (in other than a liquidation event that meets the exception in paragraph 3(f)), the issuer may have the choice to settle the redemption amount in cash or by delivery of a variable number of its own common shares with an equivalent value. For this instrument, the guidance in Section 815-40-25 should be used to evaluate whether the issuer controls the actions or events necessary to issue the maximum number of common shares that could be required to be delivered under share settlement of the contract. If the issuer does not control settlement by delivery of its own common shares (because, for example, there is no cap on the maximum number of common shares that could be potentially issuable upon redemption), cash settlement of the instrument would be presumed and the instrument would be classified as temporary equity.

Example 2. A preferred security that is not required to be classified as a liability under other applicable GAAP may have a redemption provision that states it may be called by the issuer upon an affirmative vote by the majority of its board of directors. While some might view the decision to call the security as an event that is within the control of the company because the governance structure of the company is vested with the power to avoid redemption, if the preferred security holders control a majority of the votes of the board of directors through direct representation on the board of directors or through other rights, the preferred security is redeemable at the option of the holder and classification in temporary equity is required. In other words, any provision that requires approval by the board of directors cannot be assumed to be within the control of the issuer. All of the relevant facts and circumstances should be considered.

Example 3. A preferred security that is not required to be classified as a liability under other applicable GAAP may contain a deemed liquidation clause that provides that the security becomes redeemable if the common stockholders of the issuing company (that is, those immediately prior to a merger or consolidation) hold, immediately after such merger or consolidation, common stock representing less than a majority of the voting power of the outstanding common stock of the surviving corporation. This change-in-control provision would require the preferred security to be classified in temporary equity if a purchaser

could acquire a majority of the voting power of the outstanding common stock without company approval, thereby triggering redemption.

Example 4. An equity instrument may contain provisions that allow the holder to redeem the instrument for cash or other assets upon the occurrence of events that are not solely within the issuer's control. Such events may include:

- The failure to have a registration statement declared effective by the SEC by a designated date
- The failure to maintain compliance with debt covenants
- The failure to achieve specified earnings targets
- A reduction in the issuer's credit rating.

Since these events are not solely within the control of the issuer, the equity instrument is required to be classified in temporary equity.

4.2.3.1.2 Examples in which permanent equity classification is appropriate. The following examples from ASC 480-10-S99-3A are useful in understanding under what circumstances permanent equity classification is appropriate.

Example 5. A preferred security may have a provision that the decision by the issuing company to sell all or substantially all of a company's assets and a subsequent distribution to common stockholders triggers redemption of the security. In this case, the security would be appropriately classified in permanent equity if the preferred stockholders cannot trigger or otherwise require the sale of the assets through representation on the board of directors, or through other rights, because the decision to sell all or substantially all of the issuer's assets and the distribution to common stockholders is solely within the issuer's control. In other words, if there could not be a "hostile" asset sale whereby all or substantially all of the issuer's assets are sold, and a dividend or other distribution is declared on the issuer's common stock, without the issuer's approval, then classifying the security in permanent equity would be appropriate.

Example 6. A preferred security may have a provision that provides for redemption in cash or other assets if the issuing company is merged with or consolidated into another company, and pursuant to state law, approval of the board of directors is required before any merger or consolidation can occur. In that case, assuming the preferred stockholders cannot control the vote of the board of directors through direct representation or through other rights, the security would be appropriately classified in permanent equity because the decision to merge with or consolidate into another company is within the control of the issuer. Again, all of the relevant facts and circumstances should be considered when determining whether the preferred stockholders can control the vote of the board of directors.

4.2.3.2 Presentation of redeemable stock

Redeemable stock (as defined earlier) should be reported between long-term debt and stockholders' equity, without a subtotal that might imply it is a part of stockholders' equity.

4.2.3.3 Initial and subsequent measurement of redeemable stock

Paragraph 12 of ASC 480-10-S99-3A indicates that the initial carrying amount of redeemable stock should be its fair value at the date of issuance (generally the proceeds for which it was issued or its allocated share of proceeds if issued with other freestanding financial instruments). The proceeds would be reduced by any separately recognized bifurcated derivatives or beneficial conversion feature to arrive at the initial carrying amount for the redeemable instrument. As it relates to subsequent measurement, which is addressed in paragraphs 13 to 17 of ASC 480-10-S99-3A, if the instrument is currently redeemable, it should be carried on the balance sheet at an amount not less than the maximum redemption price based on conditions that exist at the balance sheet date. If the instrument is not currently redeemable (e.g., because a contingency has not been met), but it is probable that the instrument will become redeemable (e.g., when the redemption depends solely on the passage of time), either of the following accounting methods may be used:

- Accrete changes in the redemption value over the period from the date of issuance (or, if later, from the date that it becomes probable that the instrument will become redeemable) to the earliest redemption date of the instrument using an appropriate methodology, which is usually the interest method (see illustration of this method at Section 2.6 and Section 3.5, as applicable). Changes in the redemption value are considered to be changes in accounting estimates and accounted for as such.
- Recognize changes in the redemption value (e.g., fair value) immediately as they occur and adjust the carrying value of the instrument to equal the redemption value at the end of each reporting period. This method would view the end of the reporting period as if it were also the redemption date for the instrument.

If an equity instrument is not redeemable currently (e.g., because a contingency has not been met) and redemption is not probable, subsequent adjustment is not necessary until redemption is probable. In that case, disclosure should be made of why redemption is not probable. There should be consistent application of the accounting method selected, along with appropriate disclosure of the selected policy in the footnotes to the financial statements. Moreover, disclosure of the redemption value of the equity instrument as if it were currently redeemable is required for SEC registrants that elect to accrete changes in redemption value over the period from the date of issuance to the earliest redemption date.

As is indicated in paragraph 20 of ASC 480-10-S99-3A, increases and decreases to the carrying amount of the redeemable stock as a consequence of these subsequent measurement provisions are accounted for in the same manner as dividends (i.e., generally charged to retained earnings; in the absence of retained earnings, to paid in capital; and in the absence of both, accumulated deficit). These increases and decreases also impact the EPS computation by reducing or increasing income available to common shareholders. As noted in paragraph 16(e) of ASC 480-10-S99-3A, decreases to the carrying amount would not be recognized to the extent that the decreases would reduce the carrying amount presented in temporary equity below the initial carrying amount. In other words, reductions to the carrying amount should not exceed previously recognized increases.

4.2.3.3.1 Application to Special-purpose Acquisition Companies (SPACs). In their IPOs, SPACs often issue shares that include provisions for redemption that result in the class of shares being presented in temporary equity. Specifically, the shares are redeemable if either (a) the SPAC does not complete a business combination by a specified date or (b) the holder elects to be redeemed if the SPAC does complete a business combination. Typically there also is a provision within the SPAC's charter requiring net tangible assets be maintained above a certain minimum level (e.g., $5 million). Some entities had concluded that the provision to maintain a minimum level of net tangible assets effectively limits the redemption of the redeemable shares, and as such classified that minimum amount in permanent equity. However, the SEC staff has objected to this position indicating that, since each individual share is redeemable, there is no support pursuant to ASC 480-10-S99 to exclude this amount from temporary equity.

If the redemption provisions lapse upon completion of the business combination, shares that remain outstanding may then qualify for permanent equity classification (i.e., if no other features of the shares or circumstances require temporary equity classification under the guidance in ASC 480-10-S99).

4.3 Derivative analysis of embedded features

4.3.1 Overview

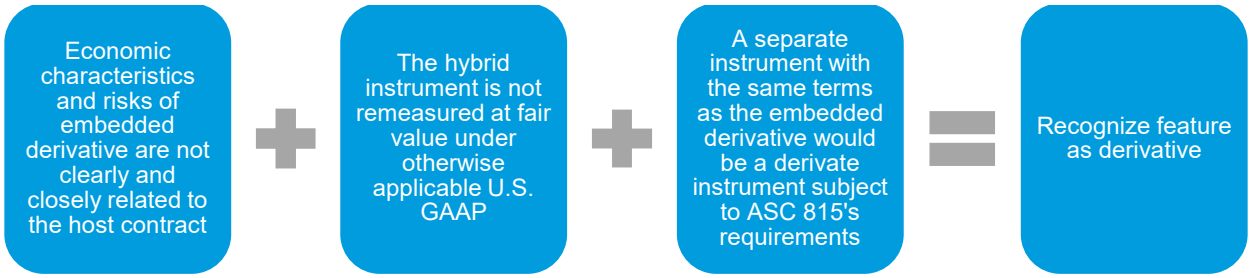
It is common for preferred stock to have embedded features that may require separate recognition as derivatives. The most common features within preferred stock that are observed in practice and sometimes require derivative recognition are conversion and redemption options. Hence, the focus of this section is on these features. However, there may be other features within a preferred stock instrument that necessitate similar consideration of the guidance that follows. The focus should be on features that can alter the amount or timing of cash flows or value of other exchanges (e.g., conversion shares).

Distinguishing between conversion and redemption options

Standard conversion options allow for conversion of the preferred stock instrument into a fixed or substantially fixed number of shares of another class or series. Standard redemption options give the holder the right to put the shares to the issuer (or the issuer the right to call the shares from the holder) at a stated amount, to be paid typically in cash or in some cases shares. Some instruments provide for conversion into a variable number of shares, the number to be determined at the time of conversion based on the fair value of the conversion shares at the conversion date to ensure that the holder receives a predetermined amount of value paid in whatever number of conversion shares it takes to arrive at that value. Assuming that this feature does not result in classification as stock-settled debt under ASC 480-10-25-14 as discussed at Section 4.2.2, we believe it would generally be appropriate to analyze this feature as a redemption option rather than a conversion option.

The determination of which embedded features must be separately recognized as derivatives is complex and is addressed in ASC 815. Specifically, ASC 815-15-25-1 requires derivative recognition for embedded features if all of the following three criteria are met:

1. The economic characteristics and risks of the embedded derivative are not clearly and closely related to the economic characteristics and risks of the host contract.
2. The hybrid instrument is not remeasured at fair value under otherwise applicable generally accepted accounting principles.
3. A separate instrument with the same terms as the embedded derivative would be a derivative instrument subject to the requirements of ASC 815. (In other words, it meets the definition of a derivative and does not qualify for one of the scope exceptions outlined at ASC 815-10-15-13.)



4.3.2 Criterion 1 of embedded derivative analysis

The first criterion of the embedded derivative analysis necessitates consideration of whether the economic characteristics and risks of the embedded derivative are clearly and closely related to the economic characteristics and risks of the host contract. When analyzing embedded features within preferred stock under this criterion, an evaluation needs to be performed to determine if the preferred stock is more akin to debt or equity. This determination is not based on the balance sheet classification of the instrument, but rather a subjective evaluation and weighting of all relevant terms and features of the instrument. That being said, it would be rare for an instrument that is required to be classified as a liability to be considered more akin to equity. The significance of this determination is that if the instrument is overall deemed to be more debt-like, equity features such as a conversion option would meet the first criterion. Conversely, if the instrument is overall deemed to be more equity-like, debt-like features such as a redemption option would meet the first criterion. It should also be noted that the conclusion on whether the preferred stock is more equity-like or debt-like can also impact the analysis of the third criterion, which is elaborated on later.

4.3.2.1 Determining the nature of the host contract

The analysis of the nature of the preferred stock host contract should be based on all stated and implied substantive terms and features, with each term and feature evaluated to determine if it is more debt-like or equity-like and weighted on the basis of relevant facts and circumstances in existence at the date of issuance. The template that follows is provided as a tool in evaluating and weighting features commonly associated with preferred stock to arrive at a conclusion on the nature of the host contract as more debt-like or equity-like.

Factors to consider	Insights on weighting certain factors	Analysis
Redemption rights (generally debt-like characteristic)		
Is redemption mandatory or contingent?	A mandatory redemption right would be given more weight. The weight placed on a contingent redemption right would be commensurate with the likelihood of redemption being triggered.	
Who holds the redemption right?	A redemption right held by an investor would be given more weight than if held by the issuer.	
Is the redemption right in the money or out of the money?	An in-the-money right would be given more weight.	
Is a conversion option also provided, and if so, how favorable is this option in comparison to the redemption right?	Less weight would be placed on a redemption right if the conversion option was more favorable.	
Are there legal restrictions and (or) solvency factors that would prohibit the issuer from redeeming the instrument?	Such restrictions and factors would reduce the weight placed on the redemption right.	
Are there issuer-specific considerations that make redemption unlikely (e.g., is the issuer thinly capitalized or unprofitable)?	Such considerations would reduce the weight placed on the redemption right.	
Conversion rights (generally equity-like characteristic unless settlement will be in a variable number of shares designed to result in a fixed amount of value)		
Who holds the conversion right?	A conversion right held by an investor would be given more	

Factors to consider	Insights on weighting certain factors	Analysis
	weight than if held by the issuer.	
Is conversion mandatory?	More weight would be placed on a mandatory conversion right.	
Is the conversion right contingent?	Less weight would be placed on a contingent conversion right, commensurate with the likelihood of it not being triggered.	
Is the conversion right in the money or out of the money?	An in-the-money conversion right would be given more weight.	
If the instrument is also redeemable, what is more likely to occur first, conversion or redemption?	Less weight would be placed on the conversion right if redemption was more likely to occur first.	
Rights upon liquidation		
Is there a stated liquidation preference?	If so, the liquidation right is a debt-like characteristic.	
Does the holder participate in the residual value of the entity?	If so, the liquidation right is an equity-like characteristic.	
Voting rights (equity-like characteristic weighted commensurately with the level of influence the rights provide)		
Does the holder have voting rights and if so, are they entitled to vote on all or limited matters?		
How much influence can the holder's class of stock exercise based on its voting rights?		
Dividend rights		
Are the dividends mandatory or discretionary?	Mandatory dividends are a debt-like characteristic, while discretionary dividends are an equity-like characteristic.	

Factors to consider	Insights on weighting certain factors	Analysis
Are the dividends stated or participating?	Stated dividends are a debt-like characteristic, while participating dividends are an equity-like characteristic.	
Are the dividends cumulative or noncumulative?	Cumulative dividends are a debt-like characteristic, while noncumulative dividends are an equity-like characteristic	
Protective covenants (debt-like characteristic weighted commensurately with the level of protection the covenants provide)		
Are there collateral requirements akin to collateralized debt?		
If the instrument contains a redemption option held by the investor (holder), is the issuer's performance upon redemption guaranteed by the parent of the issuer or otherwise?		
Does the instrument provide the holder with certain rights akin to creditor rights (e.g., the ability to force bankruptcy or a preference in liquidation)?		
Conclusion (In light of the factors to consider and the most likely outcome of the instrument, conclude as to the nature of the preferred stock host contract as more debt-like or equity-like and the weight placed on the various features in reaching that conclusion.)		

4.3.2.2 Determining if the economic characteristics and risks are clearly and closely related

Once a conclusion is reached on the nature of the preferred stock host contract, the determination can be made as to whether or not each embedded feature has economic characteristics and risks that are clearly and closely related to the economic characteristics and risks of the host contract to address the first criterion. The following table helps to illustrate this in the context of conversion and redemption options which are the most common features within preferred stock that may require derivative treatment. If the preferred stock host contract is deemed to be more debt-like in nature, the embedded derivatives should be evaluated as outlined in Chapter 2 beginning at Section 2.3.2 or Chapter 3 beginning at Section 3.3.2, as applicable.

	Conversion option	Redemption option
Debt-like host	Not clearly and closely related	May be clearly and closely related (See Section 2.3.2.1 or Section 3.3.2.1, as applicable)
Equity-like host	Clearly and closely related	Not clearly and closely related

4.3.3 Criterion 2 of embedded derivative analysis

The second criterion of the embedded derivative analysis (i.e., the hybrid instrument is not remeasured at fair value under otherwise applicable U.S. GAAP) is generally met for preferred stock unless the instrument is required to be accounted for as a liability and is subsequently measured at fair value. If the instrument is required to be accounted for as a liability but not subsequently measured at fair value, the embedded derivatives should be evaluated as outlined in Chapter 2 beginning at Section 2.3.2 or Chapter 3 beginning at Section 3.3.2, as applicable.

4.3.4 Criterion 3 of embedded derivative analysis

4.3.4.1 Determining if the feature is a derivative

Addressing the third criterion of the embedded derivative analysis (i.e., a separate instrument with the same terms as the embedded derivative would be a derivative instrument subject to the requirements of ASC 815) involves determining if the embedded feature meets the definition of a derivative as outlined beginning at ASC 815-10-15-83, and if so, whether it qualifies for one of the scope exceptions outlined at ASC 815-10-15-13.

Understanding the terminology

By definition, a derivative instrument has all of the following characteristics:

- One or more underlyings
- One or more notional amounts or payment provisions
- Requires no initial net investment or an initial net investment that is smaller than would be required for other types of contracts that would be expected to have a similar response to changes in market factors
- The contract can be settled net by any of the following means:
  - Its terms implicitly or explicitly require or permit net settlement.
  - It can readily be settled net by a means outside the contract.
  - It provides for delivery of an asset that puts the recipient in a position not substantially different from net settlement.

While an in-depth discussion of derivatives is beyond the scope of this guide, the following chart provides an indication of whether each characteristic would likely be met for standard conversion and redemption options in preferred stock instruments, and if so, the scope exception outlined at ASC 815-10-15-13 for which it may qualify.

Characteristic	Conversion option	Redemption option
Underlying	Yes, fair value of the shares into which it can be converted	Yes, fair value of the preferred stock

Characteristic	Conversion option	Redemption option
Notional amount or payment provision	Yes, number of shares into which it can be converted	Yes, redemption price
No or smaller initial net investment	Yes, the fair value of the conversion option at inception is generally less than the fair value of the underlying shares.	Yes, the fair value of the redemption option at inception is generally less than the fair value of the underlying stock.
Net settlement	Yes, if the conversion shares are readily convertible to cash or contractually the conversion option can be settled net	Yes, if the host contract is debt-like due to ASC 815-10-15-107 Yes, if the host contract is equity-like and the redeemable shares are readily convertible to cash or contractually the redemption option can be settled net
Scope exception that may be relevant	ASC 815-10-15-74(a), if the conversion option is indexed to the issuer's stock and classified in stockholders' equity as defined in ASC 815-40 and discussed at Section 5.2.2.1 and Section 5.2.2.2.	ASC 815-10-15-74(a), if the host contract is equity-like and the redemption option is indexed to the issuer's stock and classified in stockholders' equity as defined in ASC 815-40 and discussed at Section 5.2.2.1 and Section 5.2.2.2. If the host contract is debt-like, redemption options would generally not qualify for an exception, but may be clearly and closely related to the host contract in the first criterion.

As demonstrated in this chart, conversion options typically meet the definition of a derivative if net settlement exists, either contractually or because the shares that would be delivered (conversion shares) if the option is exercised are readily convertible to cash. Contractual net settlement could result from a provision for the holder to receive the as-converted value in cash. For example, this may exist in the form of a put or redemption option that allows the holder to receive the fair value of the instrument or the as-converted value in cash. An example follows.

Example: Contractual net settlement

Convertible preferred stock issued for $1,000 is redeemable in five years at the holder's option at a redemption price that is equal to the greater of the $1,000 original issuance price or the as-converted value. Because the holder has the ability to get the as-converted value in cash, we believe this in effect creates net settlement for the conversion option. The ability for redemption at the original issuance price would generally be evaluated separately as a redemption option.

If contractual net settlement does not exist for a conversion option, consideration should be given to whether the conversion shares are readily convertible to cash. This typically depends on whether the shares are publicly traded and if so, the daily transaction volume.

Are the shares readily convertible to cash?

The determination of whether the shares are readily convertible to cash needs to be considered on an ongoing basis throughout a contract's life. Delisting, an IPO or significant changes in the level of trading activity are examples of factors that could influence the conclusion as consideration needs to be given to whether the smallest increment of shares that would be delivered in accordance with each individual contract is small relative to the daily transaction volume. Assume for example that a preferred share can be converted at a conversion price that would result in the issuance of 100,000 shares of publicly traded common stock. The average daily trading volume associated with the common stock is 50,000 shares. If each share of preferred stock could only be converted in total, the 100,000 shares into which it would be exchanged is large relative to the daily transaction volume, and the common shares would not be considered to be readily convertible to cash. Many instruments permit conversion in whole or in part (i.e., in whatever increment the holder elects), in which case, generally, the common shares would be considered to be readily convertible to cash if they are actively traded. Refer to the guidance beginning at ASC 815-10-15-130 and Example 7 beginning at ASC 815-10-55-99 for additional information.

If a conclusion is reached that the conversion feature is a derivative and the preferred stock is debt-like, consideration would next be given to ASC 815-40 to determine if it qualifies for an exception to the derivative requirements by being indexed to the issuer's stock and classified in stockholders' equity. Refer to the guidance in Section 5.2.2.1 and Section 5.2.2.2 of this guide. If the preferred stock is equity-like, a conversion feature would be considered clearly and closely related such that Criterion 1 of the embedded derivative analysis is not met and derivative treatment is not required. Section 4.3.5 summarizes the accounting treatment if derivative recognition is required. If derivative recognition is not required for a conversion feature, consideration should be given to the discussion beginning at Section 4.4.

As the chart demonstrates, redemption options in debt-like preferred stock host contracts typically meet the definition of a derivative given that ASC 815-10-15-107 states that the net settlement component of a derivative exists for put and call options in debt instruments. As such, the analysis generally hinges on the first criterion in the embedded derivative analysis (i.e., the determination of whether the economic characteristics and risks associated with the redemption option are clearly and closely related to the economic characteristics and risks of the host contract). For this analysis, refer to the discussion in this guide at Section 2.3.2.1 or Section 3.3.2.1, as applicable. As is evident from ASC 815-10-15-109, this net settlement guidance does not apply to redemption options in equity-like host contracts. As such, these features in an equity-like host contract would not meet the definition of a derivative unless contractual net settlement exists or the shares subject to the redemption option are readily convertible to cash as discussed earlier. If a redemption option in an equity-like host does meet the definition of a derivative, consideration would next be given to whether it qualifies for an exception to derivative recognition by being indexed to the issuer's stock and classified in stockholders' equity. Refer to Section 5.2.2.1 and Section 5.2.2.2 for this analysis.

4.3.5 Accounting treatment if derivative recognition is required

If an embedded feature such as a conversion or redemption option requires separate recognition as a derivative asset or liability under ASC 815, it is initially and subsequently measured and carried at fair value, with changes in fair value reflected in earnings in accordance with ASC 815-15-30 and ASC 815-10-35. For additional information related to the initial recognition and fair value determinations, refer to Section 1.4 or 1.5 of this guide, as applicable. The allocation of proceeds to separately recognized derivatives will generally result in the initial preferred stock carrying amount being less than its stated preference upon liquidation or redemption, in effect creating a discount that may need to be amortized as elaborated on in Section 4.2.3.3.

4.3.6 Ongoing need for reassessment of derivative conclusions

As pointed out at ASC 815-40-35-8, there is an ongoing need to reassess certain conclusions that were reached related to potential embedded derivatives. For example, reassessment would be necessary if the terms of an instrument are modified. Additionally, if derivative treatment for a conversion or redemption option hinged on the conclusion reached on whether the shares that would be converted or redeemed are readily convertible to cash as discussed at Section 4.3.4.1, this conclusion should be reassessed on an ongoing basis given that as pointed out at ASC 815-10-55-84, the conclusion could change for various reasons including an IPO, sustained changes in daily trading value and listing or delisting of the shares on a national stock exchange. Increased trading activity could result in a conclusion that a conversion or redemption option that was initially not a derivative now is and vice versa. (Note that if a conversion option is embedded in an equity-like host contract, it would typically not meet Criterion 1 discussed in Section 4.3.2, in which case, derivative treatment would not hinge on whether the conversion shares are readily convertible to cash.) In reassessing whether or not conversion and redemption options that are deemed to be derivatives qualify for the scope exception mentioned earlier, ongoing consideration needs to be given to the requirements for equity classification as summarized at Section 5.2.2.2. If, for example, the conclusion changes related to whether an entity can demonstrate it has sufficient authorized shares to settle the conversion option, reclassification may be necessary. Additionally, there may be circumstances that cause the conclusion to change related to whether a feature is considered indexed to the entity's stock (addressed at Section 5.2.2.1). This may be the case, for example, if the conversion terms are subject to adjustment for a limited period of time as after the terms are no longer subject to adjustment, the conversion feature may be indexed to the entity's stock. It is generally not appropriate to reassess conclusions reached related to Criterion 1 discussed at Section 4.3.2 unless the instrument is subsequently modified.

4.3.6.1 Embedded feature subsequently requires derivative recognition

If upon reassessment an embedded feature that was not previously required to be recognized as a derivative requires derivative recognition, the fair value of that feature would be reclassified to an asset or liability (as appropriate) at its fair value on that date. It would continue to be subsequently measured at fair value with changes in fair value recognized through earnings. ASC 815-40-35-9 indicates that if a contract is reclassified from permanent or temporary equity to an asset or a liability, the change in fair value of the contract during the period the contract was classified as equity should be accounted for as an adjustment to stockholders' equity.

4.3.6.2 Bifurcated feature no longer requires derivative recognition

If a bifurcated feature that had been recognized as a derivative no longer should be upon reassessment, the carrying amount of the feature (fair value on the reclassification date) should generally be reclassified to shareholders' equity without subsequent adjustment to fair value. This presumes the preferred stock is classified as equity. If instead the instrument is mandatorily redeemable preferred stock classified as a liability under ASC 480-10-25-4, reference should be made to the guidance in Section 2.3.5.2 or Section 3.3.5.2 of this guide, as applicable.

4.4 ASC 470-20 considerations if the preferred stock is convertible – Before adoption of ASU 2020-06

If derivative recognition is not required for a conversion feature contained within a preferred stock instrument, prior to the adoption of ASU 2020-06, the guidance in ASC 470-20 should be considered to determine if a portion of the preferred stock proceeds should be accounted for as additional paid-in capital. Refer to Section 3.4 for this discussion, keeping in mind that preferred stock that is required to be classified as a liability would be analyzed in the same manner as convertible debt. There are nuances in how this guidance is applied to preferred stock that is required to be classified in equity (permanent or temporary), including the following:

- The Cash Conversion sections (which begin at Section 3.4.1 and end at Section 3.4.1.4) are not relevant as they apply only to liability-classified instruments as outlined at ASC 470-20-15-6.
- Most of the content on the beneficial conversion features provisions of ASC 470-20 is relevant. Namely, the content beginning at Section 3.4.2 to Section 3.4.2.2.1.3.4 is applicable; however, keep in mind that any discount resulting from the recognition of a beneficial conversion feature on an instrument that is classified in permanent or temporary equity is recognized as a return to the preferred shareholders (dividend) rather than as interest expense in accordance with ASC 470-20-35-7.

In the event the determination is made that the conversion option does not require separate recognition as a derivative or prior to the adoption of ASU 2020-06, as a beneficial conversion feature, the instrument is accounted for in the same manner as a nonconvertible security.

4.5 Subsequent accounting considerations for preferred and similar stock

4.5.1 Accounting upon triggering a down round feature – Upon adoption of ASU 2020-06

Upon adoption of ASU 2020-06, the beneficial conversion feature model as discussed in Section 4.4 is no longer applicable, and the guidance in this Section should be followed upon the triggering of a down round feature.

A down round feature is defined as follows in the ASC Master Glossary:

> A feature in a financial instrument that reduces the strike price of an issued financial instrument if the issuer sells shares of its stock for an amount less than the currently stated strike price of the issued financial instrument or issues an equity-linked financial instrument with a strike price below the currently stated strike price of the issued financial instrument. A down round feature may reduce the strike price of a financial instrument to the current issuance price, or the reduction may be limited by a floor or on the basis of a formula that results in a price that is at a discount to the original exercise price but above the new issuance price of the shares, or may reduce the strike price to below the current issuance price. A standard antidilution provision is not considered a down round feature.

ASC 260-10-25-1 and ASC 260-10-30-1 provide guidance relevant to convertible preferred stock (if the conversion feature has not been bifurcated), with down round features. This guidance applies only to entities that are required to or voluntarily present EPS. Each time a down round feature is triggered (i.e., the strike price is reduced) for one of these instruments, the effect (value created) is accounted for by an entity that presents EPS as a dividend through a reduction to retained earnings and an increase to the instrument's carrying amount. This amount also reduces income available to common shareholders in basic EPS.

The amount to be recognized as a dividend each time a down round feature is triggered is the difference between the following two amounts determined in accordance with ASC 820 immediately after the down round feature is triggered:

1. The fair value of the financial instrument (ignoring the down round feature) with the strike price that was in effect before the strike price reduction
2. The fair value of the financial instrument (ignoring the down round feature) with the reduced strike price resulting from the down round being triggered

Section 5.2.2.2.2.1 of this guide provides an example of this accounting in the context of an adjustment to the strike price of warrants. It should be noted that, while the down round feature is ignored when determining the fair value of the instrument for the purpose of this computation, all features of an instrument (including a down round feature) should be considered when it is necessary to determine the fair value of an instrument for other purposes (such as to establish its initial carrying amount). Additionally, this accounting does not apply to liability-classified convertible instruments.

4.5.2 Conversion of preferred stock in accordance with its contractual terms

When convertible preferred stock or other shares are converted to a different class of equity securities (such as common stock) pursuant to the original conversion terms, the net carrying amount of the converted stock (adjusted as necessary for accretion through the conversion date) is generally debited with that amount credited as appropriate to the par value and additional paid-in capital accounts for the shares into which the instrument was converted in accordance with ASC 470-20-40-4. Additionally, if the convertible instrument contained a beneficial conversion feature that was recognized under ASC 470-20 prior to adoption of ASU 2020-06, any remaining unamortized discount resulting from the beneficial conversion feature (or otherwise) should be recognized as a deemed dividend and deducted from income available to common stockholders in accordance with ASC 470-20-40-1.

There is no guidance specifically on point to address the contractual conversion of preferred or other stock in those circumstances where the conversion feature was required to be bifurcated and accounted for as a derivative liability at fair value. While there may be a legal conversion of the instrument, we believe this should be viewed as an extinguishment. Given that the convertible instrument is equity classified or temporary-equity classified rather than liability classified, the extinguishment is accounted for under ASC 260-10-S99-2 rather than ASC 470-50. A method of accounting that we believe would be appropriate is illustrated through the entries that follow. Assume that the fair value of the conversion option immediately prior to conversion is $5,000 and the recorded balance is $4,000. The carrying amount of the preferred stock is $50,000 and the value of the common stock issued upon conversion is $53,000 on the conversion date.

Adjust the carrying amount of the derivative to its pre-conversion fair value

	Debit	Credit
Other expense	$1,000	
Conversion option derivative liability		$1,000

Record the conversion of the preferred stock

	Debit	Credit
Conversion option liability	$5,000	
Preferred stock	50,000	
Common stock (par) and additional paid-in capital		$53,000
Equity (return from preferred holder)		2,000

As these entries illustrate, the conversion feature and other bifurcated derivatives (if any) associated with the converted amounts would be adjusted to the conversion-date fair value through earnings, after which the carrying amount of both the preferred shares that were converted and the associated bifurcated derivatives would be written off and common or other stock into which the instrument converted (conversion shares) credited for the conversion date fair value of the conversion shares. Any difference between the carrying amount of the converted preferred stock (and related derivatives) and fair value of the conversion shares is accounted for similar to a dividend to or return from preferred stockholders and subtracted from or added to net income to arrive at income available to common stockholders in the calculation of EPS.

4.5.3 Induced conversions of preferred stock

If convertible preferred stock is converted into other securities pursuant to an inducement offer as described in Section 2.5.3 or Section 3.4.2.3.2, as applicable, the excess of the fair value of the securities and other consideration transferred in the transaction over the fair value of securities issuable pursuant to the original conversion terms, if any, should be accounted for similar to a dividend on preferred stock as elaborated on in ASC 260-10-S99-2. (Refer to the illustration in Section 2.5.3 or Section 3.4.2.3.2, as

applicable; however, rather than debiting expense, retained earnings is debited for the preferred stock dividend, which will reduce income available to common stockholders in the calculation of EPS.) Refer also to the discussion that follows.

4.5.4 Modification, extinguishment and redemption of preferred stock instruments (including conversion of instruments for which the conversion feature was bifurcated as a derivative)

4.5.4.1 Overview and accounting for redemptions

SEC staff guidance codified at ASC 260-10-S99-2 addresses the redemption and induced conversions of equity-classified preferred stock (including those instruments classified as temporary equity), as well as modifications and exchanges of these instruments that are accounted for as extinguishments. While this is SEC staff guidance, we believe it would generally be appropriate for non-SEC reporting entities to also consider it given the lack of guidance otherwise on point. The guidance contained within ASC 260-10-S99 requires that redemptions of preferred stock should be accounted for in a similar manner to the treatment of dividends with the difference between the fair value of the consideration transferred to the preferred stockholders and the net carrying amount of the preferred stock subtracted from (or added to) net income to arrive at income available to common stockholders in the EPS calculation. In accordance with ASC 470-20-40-3, the fair value of the consideration transferred is reduced by any commitment-date intrinsic value of a conversion option if the redemption relates to convertible preferred stock with a beneficial conversion feature that had been recognized under ASC 470-20 prior to the adoption of ASU 2020-06.

While the guidance in the previous paragraph does not specifically address the accounting in circumstances in which the instrument being redeemed has embedded features that were bifurcated and are accounted for as derivatives, we believe a reasonable approach would be to continue to adjust the derivatives to fair value through earnings to the redemption date and include the then-current fair value of the bifurcated derivatives in the carrying value of the preferred stock in the calculation described in that paragraph. As indicated in Section 4.5.2, similar accounting should generally be applied in circumstances involving the conversion of preferred stock where the conversion feature had been bifurcated and is accounted for as a derivative.

4.5.4.2 Determining if a modification or exchange is an extinguishment

The accounting prescribed in ASC 260-10-S99-2 also applies to modifications and exchanges of equity or temporary-equity classified preferred stock instruments that are accounted for as extinguishments. While guidance exists in ASC 470-50 to address the accounting for debt modifications, including preferred stock that is accounted for as a liability, there is no comparable guidance to address the accounting for modifications to preferred stock instruments that are accounted for as equity or temporary equity, which necessitates the subjective determination of whether a modification or exchange represents an extinguishment. This issue was discussed by SEC staff member T. Kirk Crews in a speech he gave at the 2014 Forty-Second AICPA National Conference on Current SEC and PCAOB Developments. His view was that the legal form and whether or not new preferred stock is issued should not be viewed as determinative factors, but rather one data point that should be considered in the overall analysis. Based on the observations outlined in the speech, the following acceptable approaches have been employed in practice:

- *Qualitative approach (most common):* Consider the significance of any contractual terms added, removed or changed, as well as the business purpose for the changes and how the changes may influence the economic decisions of the investor. If these changes are judged to be significant, the amendments or exchange would be treated as an extinguishment; otherwise, the changes are considered a modification to the preferred stock.
- *Fair value approach:* If the amendments result in a 10 percent or greater change in the fair value of the preferred stock, it is considered substantially different, and the amendment or exchange would be

accounted for as an extinguishment. If the change is less than 10 percent, the preferred stock was simply modified.

- *Cash flow approach:* This approach is similar to the fair value approach except that contractual cash flows are evaluated, rather than the fair value, similar to the approach outlined in ASC 470-50 for debt modifications.

We would generally expect the cash flow approach to be applied only when the preferred stock has well-defined periodic cash flows.

4.5.4.3 Accounting for extinguishments and modifications

If the conclusion is reached that an extinguishment occurred, the transaction is accounted for under ASC 260-10-S99-2 as described at Section 4.5.4.1. On the other hand, modifications are generally accounted for by analogy to the guidance in ASC 718-20-35, which is applicable to modifications of stock-based compensation instruments classified as equity. This would result in the excess of the fair value of the preferred stock as modified over the fair value of the preferred stock immediately prior to modification, if any, to generally be reflected as a deemed dividend to the preferred holders, which would impact income available to common shareholders for purposes of calculating EPS. In certain circumstances, it may be appropriate to reflect the debit as an expense (e.g., compensation for agreeing to restructure). Given the lack of guidance and multiple approaches applied in practice in evaluating modifications and concluding if an extinguishment occurred, we recommend that reporting entities have a rational basis for the approach followed as well as consistently apply that approach where warranted by similar facts and circumstances. In addition, the approach followed by the entity should be disclosed.

4.6 Delayed issuance of preferred or other stock

4.6.1 Overview

Entities occasionally enter into arrangements to issue shares to investors at subsequent dates. These arrangements are typically entered into contemporaneously with a current issuance or sale of shares. While the discussion that follows is focused on issuances of preferred stock, where such an arrangement most commonly exists in practice, the same concepts generally apply to issuances of common stock. The delayed issuance of preferred stock may be mandatory or optional. Such arrangements are often contingent upon the company completing milestones, such as a specified phase in a clinical trial, and are most often encountered in the pharmaceutical, biotech and technology sectors. These arrangements may also be referred to as tranche preferred share issuances. The following is an example of one such arrangement incorporated into a stock purchase agreement.

Example: Delayed issuance of preferred stock

Upon the achievement of the Milestone (as defined), the Company shall sell, and the Purchaser shall purchase 200,000 shares of Series B-2 Preferred Stock of the Company, at a price of $15.00 per share.

In this example, the Company is obligated to sell, and the investor is obligated to purchase, shares at a fixed price at a later date. Other arrangements may obligate only one party to the transaction, which would be the case if in this example the Company could decide whether or not to request the delayed issuance. In other circumstances commonly observed, entities extend rights to participate in future offerings such that if the entity subsequently conducts an equity offering, pre-existing investors will have the right to participate in the future offering on the same terms as new investors. This latter arrangement generally does not require upfront accounting recognition given that the entity is not obligated to conduct a subsequent offering, nor is the investor obligated to participate if a subsequent offering occurs. However, it should be noted that in those circumstances where one or both parties is contractually obligated (contingently or otherwise) to sell or purchase shares at a future date at a pre-established price,

separate accounting treatment for this right or obligation may be necessary. In determining the appropriate accounting for such an arrangement, it is necessary to first determine whether the arrangement would be considered a freestanding or embedded financial instrument.

4.6.2 Determining if the future tranche right is freestanding or embedded

As defined in ASC 480, a freestanding financial instrument is a financial instrument that is either:

- Entered into separate and apart from any of the entity's other financial instruments or equity transactions
- Entered into in conjunction with some other transaction and is legally detachable and separately exercisable

Given that delayed issuances of preferred stock are typically entered into in conjunction with an initial preferred stock issuance, it will generally be necessary to consider whether the arrangement is considered to be legally detachable and separately exercisable. In the context of a future right or obligation to issue preferred shares in a later tranche entered into in conjunction with an initial preferred stock issuance, if either the initial preferred shares or the future right (or obligation) to issue preferred shares (referred to hereafter as the future tranche right) can be legally detached (e.g., sold or transferred) and separately exercised, then the instrument would be considered freestanding. In other words, if the holder is not contractually restricted from having the ability to sell the initial preferred shares while retaining the future tranche right, or vice versa, the instruments would likely be considered freestanding. Consideration must also be given to whether the initial preferred shares would remain outstanding upon exercise of the future tranche right, which is typically the case. If the initial preferred shares can only be sold or transferred along with the future tranche right, the instruments would typically not be viewed as freestanding. A careful assessment of all contractual restrictions or provisions related to the transfer of these instruments is necessary.

4.6.3 Accounting analysis for freestanding future tranche rights

If the future tranche right is considered to be freestanding, it should be evaluated in accordance with Chapter 5 to determine its classification as an asset, liability or equity. This entails giving consideration to ASC 480 and ASC 815-40. Under ASC 480, a financial instrument (other than a share) would be classified as a liability if it embodies an obligation, either conditional or unconditional, to repurchase the issuer’s equity shares. Accordingly, if the arrangement conditionally or unconditionally obligates the entity (as opposed to giving the entity the option) to issue preferred or other shares that contain a redemption feature (that is not within the entity’s control), that would necessitate liability classification of the future tranche right or obligation and the instrument would be measured in accordance with ASC 480-10-30 and ASC 480-10-35.

If the determination is made that the future tranche right is not a liability under ASC 480, the freestanding instrument must next be analyzed under ASC 815 to determine its balance sheet classification and to determine whether the instrument is a derivative in its entirety. As noted at ASC 815-40-15-5, the classification guidance in ASC 815-40 should be considered for all freestanding financial instruments that are potentially settled in an entity’s own stock that are not accounted for under ASC 480, regardless of whether the instruments meet the definition of a derivative. ASC 815-40 contains the requirements for an instrument to be indexed to a company’s own stock and classified in stockholders’ equity, which are also discussed in Chapter 5. As is further noted in Chapter 5, the classification under ASC 815 should be reassessed at each balance sheet date.

If the future tranche right is required to be accounted for as an asset or liability and continuously adjusted to fair value through earnings, in allocating the initial proceeds from the preferred stock issuance, proceeds would first be allocated to the future tranche right based on its fair value and the remaining proceeds would be allocated to the initial preferred shares.

If the future tranche right does not require ongoing fair value measurement as an asset or liability, the allocation of the proceeds to the two components (the initial preferred shares issued and the future tranche right) would be done proportionately based upon their relative fair values.

4.6.4 Accounting analysis for embedded future tranche rights

If the future tranche right is determined to be an embedded, rather than freestanding, financial instrument, the provisions of ASC 815-15 should be considered to determine whether the right or obligation to issue the preferred shares component should be bifurcated and accounted for as a derivative. As discussed in Section 4.3.1, ASC 815-15-25-1 requires derivative recognition for embedded features if all of the following three criteria are met:

1. The economic characteristics and risks of the embedded derivative are not clearly and closely related to the economic characteristics and risks of the host contract.
2. The hybrid instrument is not remeasured at fair value under otherwise applicable U.S. GAAP.
3. A separate instrument with the same terms as the embedded derivative would be a derivative instrument subject to the requirements of ASC 815.

In considering the first criterion, typically bifurcation is not required as the economic characteristics and risks of a right or obligation to purchase shares are generally clearly and closely related to a host contract in the form of the same shares. As it relates to the third criterion and whether net settlement exists, in most cases the agreements do not provide for net settlement and the future tranche rights typically do not relate to publicly traded stock or stock that otherwise could be readily converted to cash. Additionally, even if net settlement and the other required characteristics of a derivative exists, the scope exception under ASC 815-10-15-74(a) may apply to an instrument that is: (a) indexed to an entity's own stock and (b) classified in stockholders' equity.

If the future tranche right is required to be bifurcated and accounted for as a derivative pursuant to ASC 815-15 it would be continuously adjusted to fair value through earnings. In allocating the initial proceeds from the preferred stock issuance, proceeds would first be allocated to the future tranche right based on its fair value and the remaining proceeds would be allocated to the initial preferred shares.

If separate recognition of the tranche right was not required, all of the proceeds would be allocated to the initial preferred stock issuance.

4.7 Preferred stock dividends

4.7.1 Overview

Dividends on equity securities are generally recognized when declared, as at that point in time, the entity becomes obligated to pay them. As the name implies, preferred stockholders typically are entitled to dividends before dividends can be paid to more subordinate classes of preferred or common stock. Preferred dividends are sometimes cumulative, whereby specific dividend rights are outlined in a company's certificate of designation (Certificate) as a fixed annual amount (expressed either in dollars or a fixed annual percentage of the preferred stock's original issuance price), that the holder is entitled to if and when declared. The Certificate generally indicates circumstances under which the holder would be entitled to receive any cumulative unpaid dividends even if not declared. For example, unpaid preferred dividends may become payable upon the declaration of a dividend to a more subordinate class of shareholders, redemption of the preferred stock, its conversion into common stock, a sale or change in control of the entity (both often referred to collectively as deemed liquidation events), or the liquidation of the entity. There is limited authoritative guidance to address the accounting for cumulative dividends and the accounting for dividends when there is a deficit in retained earnings. As such, these matters, as well as the accounting for dividends on increasing rate preferred stock, are addressed in the sections that follow.

4.7.1.1 Cumulative dividends on nonredeemable preferred stock classified as equity

For equity-classified preferred stock that does not have provisions for redemption that are outside the control of the issuer (referred to as nonredeemable preferred stock), cumulative dividends that the entity is legally obligated to pay should be accrued as they are earned. An example of this would be when the terms of the preferred stock instrument require that the entity pay dividends as they are earned, regardless of whether they are declared. Reference should also be made to Section 4.7.1.5 for perpetual instruments that are required to pay dividends at rates that increase in subsequent years.

Dividends that have not yet been declared by the board of directors and for which there is no legal obligation to pay unless declared should not be recognized until declared by the board of directors. This is consistent with nonauthoritative guidance in AICPA Technical Questions and Answers Section 4210.04, which states, in part:

> Inquiry — A corporation has cumulative preferred stock. It has not paid any dividends on this stock in the last three years. Should the corporation accrue the preferred dividends in arrears?
>
> Reply — Generally, preferred stock contains a cumulative provision whereby dividends omitted in previous years must be paid prior to the payment of dividends on other outstanding shares [i.e., a "dividend stopper" provision]. Since dividends do not become a corporate liability until declared, no accrual is needed.

It is important to note that while recognition may not be required, consideration should be given to the disclosure requirements of ASC 505-10-50 for arrearages in cumulative preferred dividends, and to ASC 260 for the ramifications of cumulative dividends to EPS.

In some cases, the legal obligation to pay dividends is contingent, in which case it would be appropriate to recognize the dividends when the contingency occurs. For example, a cumulative preferred stock instrument may require payment of all accumulated and unpaid dividends if the entity declares a dividend on its common shares, or if the holder exercises an option to convert its preferred shares to common stock. If the entity declares a dividend on its common shares, the entity should accrue a liability for the cumulative unpaid dividends on the preferred stock instrument even if it has not formally declared payment of such dividends. Similarly, for those dividends that become payable upon conversion, a liability should be recognized at conversion (if not paid).

Some entities have a policy of recognizing cumulative dividends as they are earned (regardless of declaration) if the preferred holder has the ability or an unconditional right to trigger payment. Examples include the preceding scenario whereby the holder has a noncontingent conversion option, and if exercised, cumulative dividends are required to be paid in cash. A company following such a policy would recognize the liability for the dividends as they accrue rather than waiting until the conversion option was triggered. The accounting policy that is elected for the recognition of dividends when the preferred holder has the ability or an unconditional right to trigger payment should be consistently applied.

With the exception of redeemable preferred stock (discussed next) and increasing rate preferred stock discussed in Section 4.7.1.5, we believe the recognition of unpaid dividends should be through a liability and not through an increase to the carrying amount of the preferred stock.

4.7.1.2 Dividends on redeemable preferred stock that meets the requirements to be classified in temporary equity

As more fully discussed in Section 4.2.3 of this guide, the SEC staff's guidance on redeemable securities in ASC 480-10-S99-3A addresses the accounting for preferred stock instruments that contain redemption features that are not within the entity's control. Such instruments are required to be classified in temporary equity, and subsequently measured at, or accreted up to, the redemption amount, including any dividends that would be paid at redemption. We believe it is preferable (though not required) that private companies follow this guidance. We also believe a private company that does not follow the subsequent measurement provisions outlined in Section 4.2.3.3 of this guide for its redeemable stock

should account for cumulative dividends consistent with the guidance in Section 4.7.1.1. In other words, it would not be appropriate for a private company to recognize accrued dividends through an adjustment to the carrying amount of its redeemable preferred stock unless it is also adjusting the carrying amount of the preferred stock to its redemption value in accordance with the guidance in Section 4.2.3.3.

4.7.1.3 Dividends on mandatorily redeemable preferred stock classified as a liability

As more fully discussed in Section 4.2.1 of this guide, ASC 480-10-25-4 requires liability treatment for certain mandatorily redeemable financial instruments. Cumulative dividends on mandatorily redeemable stock instruments classified as liabilities that will become payable upon settlement of the instrument (whether or not declared), are reflected in the subsequent measurement of the financial instrument as interest expense.

4.7.1.4 Recognition of dividends when there is a deficit in retained earnings

Generally, dividends are recognized through a debit to retained earnings. Questions often arise regarding the equity component that should be debited for dividends on equity-classified shares when the entity has an accumulated deficit. We believe consideration needs to be given to the entity's governing documents and any state laws in the jurisdiction in which it is incorporated that specifically address the equity accounts from which distributions to stockholders can be made. For example, as noted in AICPA Technical Questions and Answers Section 4210.01, state law may require that liquidating or other dividends in excess of prior year earnings be charged to accounts such as "capital repayment," "capital returned," or "liquidating dividends," which appear on the balance sheet as offsets to paid-in capital.

If not addressed by the entity's governing documents or relevant state laws, dividends in excess of retained earnings are generally accounted for as follows:

- As a reduction to APIC until APIC has been reduced to zero, after which the accumulated deficit would be increased because APIC should not be reduced below zero. SEC registrants are required to follow this approach for redeemable stock within the scope of the guidance in ASC 480-10-S99.
- As an increase to the accumulated deficit.

The accounting policy followed should be consistently applied and appropriately disclosed.

4.7.1.5 Accounting for dividends on increasing rate preferred stock

Certain preferred stock instruments are required to pay dividends at a stated rate that increases in subsequent years and may eventually level off at a higher perpetual rate. Generally, it is not appropriate to recognize the dividends according to the stated rates. There is SEC staff guidance included in ASC 505-10-S99-7 that addresses the accounting for nonredeemable instruments with dividend features of this nature, and it results in recognition of imputed dividends in the early years of these instruments through a decrease to retained earnings and an increase to the carrying amount of the preferred stock, in a manner that produces a constant rate of effective dividends. (Note that the accounting for redeemable instruments is addressed in ASC 480-10-S99-3 and summarized in Section 4.2.3.3 of this guide.) These instruments are typically issued at a discount to compensate the holder for the lower amount of dividends in the early years. This discount equates to prepaid dividends that should be amortized to retained earnings using a discount rate that equals the market rate for comparable preferred stock without consideration of dividends. While this guidance is for SEC reporting entities, it is consistent with the requirement to use the interest method for redeemable preferred stock instruments and for debt instruments. The following example illustrates this accounting.

Example: Accounting for increasing rate preferred stock

A company issues nonredeemable preferred stock with a $100 par value, on January 1, 20X7. The stock, by its terms, will pay no dividends during the first three years. The stock will pay cumulative dividends at an annual rate of $7 per share beginning in 20Y0. At the time of issuance, seven percent

was considered to be a market rate for this issuer and this type of instrument. The stock was issued at a discount to par value given the lack of dividends for the first three years. The imputed dividend amount and carrying amount of the stock over the three-year period preceding the commencement of dividends is a present value computation whereby the number of periods (three), the discount rate (7 percent) and the future value ($100) are known. The beginning and end of year carrying amounts for a share of this preferred stock as adjusted for dividends of 7 percent applied to the beginning of year balance are shown in the table that follows:

Year	Beginning of year	Imputed dividend	End of year
20X7	$81.63	$5.71	$87.34
20X8	$87.34	$6.12	$93.46
20X9	$93.46	$6.54	$100.00

In 20Y0 and subsequent years, payment of the stated dividend of $7 per share will result in the same effective 7 percent rate as the preceding three years when no dividend was paid.

Exhibit: High-level overview of the accounting for convertible preferred stock

The chart that follows provides a high-level overview of the accounting for convertible preferred stock when (a) the conversion feature is required to be separately recognized as a derivative in accordance with ASC 815 or as a beneficial conversion feature in accordance with ASC 470-20 prior to the adoption of ASU 2020-06 and (b) the conversion feature is not required to be separately recognized. Sections of this guide are referred to in the chart and should be considered along with the authoritative guidance to supplement this overview. This chart applies only to equity-classified preferred stock instruments (either permanent or temporary). Refer to the exhibit at the end of Chapter 2 or Chapter 3, as applicable, for preferred stock instruments that are classified as liabilities.

	Derivative (Section 4.3)	**Beneficial conversion feature (Section 4.4) – Prior to adoption of ASU 2020-06**	**No separate recognition**
Balance sheet classification and initial measurement of the conversion option	Conversion option is accounted for as a liability at fair value (Section 4.3.5)	A portion of the proceeds equal to the intrinsic value is recognized in additional paid-in capital (Section 3.4.2.1).	N/A (The conversion option is not separately recognized.)
Subsequent measurement considerations	The conversion option is subsequently measured at fair value with changes in fair value recognized in earnings (Section 4.3.5). The discount may need to be amortized as elaborated on at Section 4.2.3.3.	The amount in additional paid-in capital is not subsequently adjusted; however, the discount should be amortized as a return to the preferred shareholders (Section 3.4.2.2).	N/A
	Reassess whether derivative conclusions remain appropriate (Section 4.3.6)		
Ongoing reminders (in part)	Recognize additional derivative amounts as appropriate if dividends accrue and are convertible	Account for contingent conversion options and conversion prices that reset in accordance with Section 3.4.2.2.1, and beneficial conversion features on dividends that are paid in kind in accordance with Section 3.4.2.1.4	Prior to adoption of ASU 2020-06, account for contingent conversion options and conversion prices that reset in accordance with Section 3.4.2.2.1, as applicable, and beneficial conversion features on dividends that are paid in kind in accordance with Section 3.4.2.1.4. Upon adoption of ASU 2020-06, the triggering of a down-round provision is recognized in accordance with Section 4.5.1.
Accounting upon conversion	Account for as an extinguishment as	Account for as a conversion with	Account for as a conversion as outlined at

	Derivative (Section 4.3)	Beneficial conversion feature (Section 4.4) – Prior to adoption of ASU 2020-06	No separate recognition
	outlined at Section 4.5.2	recognition of any unrecognized discount as outlined at Section 4.5.2 or Section 4.5.3 (if induced conversion)	Section 4.5.2 or 4.5.3 (if induced conversion)
Accounting upon modification	Refer to Section 4.5.4.2 in making the determination as to whether modification or extinguishment accounting is appropriate, and account for accordingly with consideration given to Section 4.5.4.3 Reassess conclusions reached on the accounting for any conversion features and other potential derivatives in light of the modifications		
Accounting upon extinguishment	Account for in accordance with Section 4.5.4.3		

Chapter 5: Accounting for warrants and other equity-linked instruments

5.1 Overview

It is not uncommon for debt issuances and equity offerings to include warrants or other freestanding instruments to purchase or issue common or preferred stock, hereafter referred to as equity-linked instruments. Warrants are the most common type of instrument and generally give an investor or lender (as the holder) the option to purchase a stated number of the issuer's shares at a stated exercise price and constitute a written call option to the issuer. In some cases, companies issue written put options on their shares, which give the holder the right to sell certain securities back to the company. In addition to options for which exercise is at the election of one of the parties to the transaction, companies sometimes enter into forward contracts or commitments that require them to issue or sell a certain number of shares and require the other entity (e.g., investor or counterparty) to purchase those shares at a predefined price and settlement date (or period). There are many variations of equity option and forward contracts, some of which are freestanding instruments and some of which are embedded in either debt or preferred or other stock. The accounting analysis related to these instruments is complex and dependent upon whether the instrument or feature in question is considered to be freestanding or embedded. It is important to note the following when applying the guidance in this chapter:

- Reference should be made to Section 1.2 for guidance in determining if an instrument or feature is freestanding or embedded
  - ASC 480 (and therefore Section 5.2.1 of this guide) does not apply to embedded features.
  - The starting point for analyzing embedded equity-linked features is the guidance in Section 2.3 or Section 3.3, as applicable, (for features embedded in a debt agreement) and Section 4.3 (for features embedded in preferred and similar stock), given that the applicability of Section 5.2.2 to embedded features is limited to those features that are determined to be a derivative that is not clearly and closely related to the host contract, as is elaborated on in these sections.
- This chapter is not applicable to share-based compensation arrangements that are within the scope of ASC 718 or ASC 505-50 (prior to it being superseded by ASU 2018-07.

This chapter addresses the balance sheet classification and ongoing measurement of equity-linked instruments in Section 5.2. Section 5.3 provides guidance specific to accelerated share repurchase programs.

This chapter incorporates amendments applicable to the accounting for equity-linked instruments brought forth by ASU 2020-06. Refer to Appendix C for additional information on ASU 2020-06.

5.2 Determining the balance sheet classification and ongoing measurement

ASC 480 and ASC 815 are the relevant guidance to consider in determining if an equity-linked instrument should be classified as an asset or liability or should be classified as equity. The balance sheet classification impacts the ongoing measurement as generally instruments that are classified as equity are not subsequently remeasured, while those that are classified as assets or liabilities often require ongoing fair value measurement.

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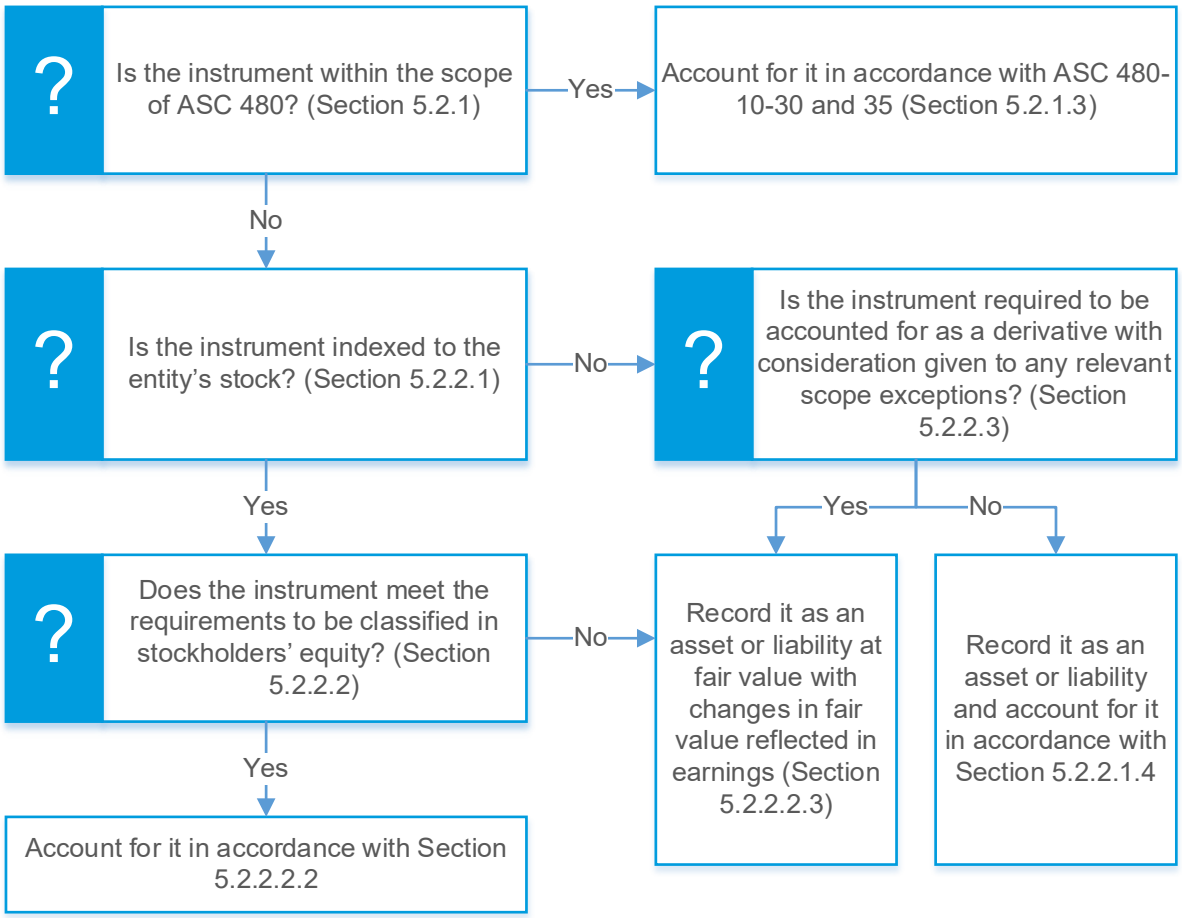
It is not uncommon for entities to be unpleasantly surprised by the fact that certain instruments, such as warrants and other obligations to issue shares, can require separate recognition as liabilities and ongoing fair value measurement. Examples of some of the more common such instruments with references to the relevant guidance in this chapter include:

- Warrants, or warrants to purchase shares, that can be put back to the company for cash or other assets, including those that can only be put upon the occurrence of an event that is not within the company's control (Section 5.2.1.1)
- Other obligations to issue puttable shares (Section 5.2.1.1)
- Warrants (or other obligations to issue shares) that provide for adjustments to the terms (e.g., exercise price, number of shares) that cause the instrument to not be indexed to the entity's own stock (Section 5.2.2.1)
- Warrants or other equity-linked instruments that require net cash settlement or permit the holder to elect net cash settlement, including upon the occurrence of an event that is not within the company's control (Section 5.2.2.2)
- Warrants or other obligations to issue shares that are required to be registered with the SEC, prior to the adoption of ASU 2020-06 (Section 5.2.2.2.1.1)
- Warrants or other obligations to issue an unlimited number of shares, or a number of shares that exceeds the number of shares that the company has authorized and available for issuance (Sections 5.2.2.2.1.2 and 5.2.2.2.1.3)

The following flowchart summarizes a logical approach to follow when performing the accounting analysis for the issuance of equity-linked instruments. The various steps of the process are referenced to the discussion that follows.



To appropriately apply the guidance in ASC 480 and ASC 815, it is important to review the contract and understand how it will or may be settled. As elaborated on at Section 5.2.1, certain provisions of ASC 480 apply to contracts that could be settled in cash and other assets, and other provisions apply to contracts that may be settled in a variable number of shares. Additionally, the form of settlement impacts the balance sheet classification under ASC 815-40 as elaborated on at Section 5.2.2.2. For this reason, the forms of settlement are defined and illustrated as follows.

Understanding the terminology

The following are key terms used in ASC 815-40, along with their definitions from the Master Glossary of the ASC:

- **Physical settlement:** "The party designated in the contract as the buyer delivers the full stated amount of cash to the seller, and the seller delivers the full stated number of shares to the buyer."
- **Net cash settlement:** "The party with a loss delivers to the party with a gain a cash payment equal to the gain, and no shares are exchanged."
- **Net share settlement:** "The party with a loss delivers to the party with a gain shares with current fair value equal to the gain."

The table that follows applies these definitions in the context of the settlement of a few common equity-linked instruments.

Physical settlement	Net cash settlement	Net share settlement
Warrant exercise: The warrant holder has the option to purchase 100 shares of the company at a $5 per share exercise price for a stated period of time. Assume that the warrant is exercised when the shares have a fair market value of $9. (Since the warrant is an option, the holder would not exercise the warrant unless the fair value of the shares at the time of exercise exceeds the exercise price.)		
The warrant holder pays $500 ($5 x 100 shares) in exchange for 100 shares.	No shares exchange hands. The company makes a cash payment for the gain of $400 to the warrant holder, determined as the amount by which the $9 fair value of a share to be purchased exceeds the $5 exercise price, multiplied by the 100 shares to be purchased.	No cash exchanges hands. The company delivers 44 shares to the warrant holder, determined by dividing the $400 gain in the preceding scenario by the $9 fair value of a share.
Warrant redemption: The warrant holder has the option to purchase 100 shares of the company at a $5 per share exercise price or put the warrant back to the company for a $2 per warrant redemption price. Assume that the shares are worth only $1 at the expiration date, such that the warrants are out of the money and the holder elects to put the warrant back to the company.		
The company pays $200 ($2 x 100 warrants) in exchange for the warrants.	The company makes a cash payment for the gain of $200 to the warrant holder, determined as the amount by which the $2 per warrant redemption price multiplied by the 100 warrants to be purchased exceeds the value (zero) of the warrants.	No cash exchanges hands. The company delivers 200 shares to the warrant holder, determined by dividing the $200 gain in the preceding scenario by the $1 fair value of a share.

Physical settlement	Net cash settlement	Net share settlement
Settlement of forward contract, fair value of the shares exceeds purchase price: The company is obligated to sell, and the investor is obligated to purchase, 100 shares at a $5 per share price at a future date. Assume that the shares have a fair market value of $9 when the contract is settled.		
The investor pays $500 ($5 x 100 shares) in exchange for 100 shares worth $900 ($9 x 100 shares).	No shares exchange hands. The company makes a cash payment to the investor for the investor's gain of $400, attributable to the ability to purchase shares worth $900 for $500.	No cash exchanges hands. The company delivers 44 shares of its stock to the investor, determined by dividing the $400 gain by the $9 fair value of the shares.
Settlement of forward contract, purchase price exceeds the fair value of the shares: The company is obligated to sell, and the investor is obligated to purchase, 100 shares at a $10 per share price at a future date. Assume that the shares have a fair market value of $6 when the contract is settled.		
The investor pays $1,000 ($10 x 100 shares) in exchange for 100 shares worth $600 ($6 x 100 shares).	No shares exchange hands. The investor makes a cash payment to the company for the company's gain of $400, attributable to the ability to sell shares worth $600 for $1,000.	No cash exchanges hands. The investor delivers 67 shares of the company's stock to the company, determined by dividing the $400 gain by the $6 fair value of the shares.

It is not uncommon for an instrument to provide for multiple forms of settlement. A warrant may, for example, require physical settlement in general, but give the holder the option for net share settlement or net cash settlement under certain circumstances, such as a change in control. As will be evident from the discussion that follows, the potential forms of settlement and the party that is in control of the forms of settlement are relevant to the analysis.

5.2.1 ASC 480 considerations

The starting point in the analysis is generally to determine if the instrument is within the scope of ASC 480, which applies to freestanding financial instruments with characteristics of both liabilities and equity. In other words, ASC 480 does not apply to embedded features. As such, if an equity-linked feature such as a put option is determined to be embedded in a debt or preferred (or similar) stock instrument, reference should be made to Chapter 2, Chapter 3 or Chapter 4 of this guide, as appropriate, for the application of ASC 480 to the debt or stock instrument as a whole. In the context of equity-linked instruments that are not issued in the form of debt or a share, and are freestanding rather than embedded, ASC 480 requires liability classification (or, in some cases, asset classification) for: (a) financial instruments that embody an obligation to repurchase equity shares (or are indexed to such an obligation) by transferring cash or other assets (discussed in Section 5.2.1.1) and (b) certain obligations to issue a variable number of shares (discussed in Section 5.2.1.2).

5.2.1.1 Obligations to repurchase the issuer's shares

ASC 480-10-25-8 requires that a financial instrument other than an outstanding share should be classified as a liability (or asset in certain circumstances[8]) if, at inception, it: (a) embodies an obligation to repurchase the issuer's equity shares or is indexed to such an obligation and (b) requires or may require

[8] As elaborated on in ASC 480-10-25-12, instruments such as forward purchase contracts and combined options can both embody obligations and contain characteristics of assets. When that is the case, the instrument's classification as an asset or liability depends on its fair value on a given reporting date.

the issuer to settle the obligation by transferring assets. An obligation is defined in ASC 480-10-20 as a conditional or unconditional duty or responsibility. As such, as is pointed out at ASC 480-10-25-9, any obligations that permit the holder to require the issuer to transfer cash or other assets (rather than shares) result in liabilities, even if the obligation is conditional. Conversely, options that permit (rather than require) the issuer to repurchase the shares are not subject to ASC 480. If there are conditional circumstances under which repurchase would be required and those circumstances are not solely within the control of the issuer, it would constitute an obligation of the issuer.

The following are examples of instruments that are typically subject to this paragraph of ASC 480, assuming that the contract is to be physically or net cash settled. (Refer to Section 5.2.1.2 of this guide for guidance regarding freestanding contracts that are to be net share settled.)

- Written put options
- Forward purchase contracts
- Warrants that are puttable
- Warrants to purchase shares that are puttable

As it relates to the last two preceding bullet points, it is evident from the implementation guidance in ASC 480-10-55 that when determining whether a freestanding financial instrument, such as a warrant or forward contract, is subject to this guidance, consideration needs to extend beyond the contractual provisions of the freestanding instrument to the underlying shares to determine whether a potential obligation to repurchase the underlying shares exist. For example, a company may issue a warrant that, if exercised, obligates it to issue shares that are puttable. The warrant would be a liability under ASC 480-10-25-8, even if the warrant itself has no contractual provisions that would subject it to this guidance. The examples that follow serve to illustrate this as well as the overall application of this guidance.

5.2.1.1.1 Examples of obligations to repurchase equity shares. The following example is from ASC 480-10-55-31.

> **Puttable Warrant that May Require Cash Settlement**
>
> Entity A issues a puttable warrant to Holder. The warrant feature allows Holder to purchase 1 equity share at a strike price of $10 on a specified date. The put feature allows Holder instead to put the warrant back to Entity A on that date for $2, and to require settlement in cash. If the share price on the settlement date is greater than $12, Holder would be expected to exercise the warrant, obligating Entity A to issue a fixed number of shares in exchange for a fixed amount of cash. That feature does not result in a liability under paragraphs 480-10-25-8 through 25-12. However, if the share price is equal to or less than $12, Holder would be expected to put the warrant back to Entity A and could choose to obligate Entity A to pay $2 in cash. That feature does result in a liability, because the financial instrument embodies an obligation that is indexed to an obligation to repurchase the issuer's shares (as the share price decreases toward $12, the fair value of the issuer's obligation to stand ready to pay $2 begins to increase) and may require a transfer of assets. Therefore, paragraphs 480-10-25-8 through 25-12 require Entity A to classify the instrument as a liability.

In this example, the holder has an unconditional right to put the warrant back to the issuer in exchange for cash. Keep in mind that the warrant would be classified as a liability even if the holder's ability to put the warrant back was conditional. To illustrate, certain warrants permit the holder to put the warrant back to the issuer upon the occurrence of a contingent event, such as a change in control. As noted at ASC 815-40-55-2, the occurrence of a change in control is not within the issuer's control. As such, this would constitute a conditional obligation of the issuer, and the warrant generally would be classified as a liability. In practice, the guidance of ASC 815-40-55-3 and 55-4 and ASC 480-10-S99-3A(3)(f) is referred to by analogy, and as a limited exception that rarely comes into play, this redemption feature would not trigger liability treatment for the warrant if all of the holders of equally and more subordinated equity instruments would always be entitled to receive the same form of consideration upon the occurrence of the event that

gives rise to the redemption. (In other words, all subordinate shareholder classes would also be entitled to redeem for cash upon the occurrence of a change in control.) As the following examples from ASC 480-10-55-32 and 55-33 demonstrate, the outcome is the same (i.e., liability classification for the warrant) if the shares that can be purchased through the warrant are puttable, rather than the warrant being puttable.

> **Warrant for Shares that Are Puttable that May Require Cash Settlement**
>
> Entity B issues a warrant for shares that can be put back by Holder immediately after exercise of the warrant. The warrant feature allows Holder to purchase 1 equity share at a strike price of $10 on a specified date. The put feature allows Holder to put the shares obtained by exercising the warrant back to Entity B on that date for $12, and to require physical settlement in cash. If the share price on the settlement date is greater than $12, Holder would be expected to exercise the warrant obligating Entity B to issue a fixed number of shares in exchange for a fixed amount of cash, and retain the shares. That feature alone does not result in a liability under paragraphs 480-10-25-8 through 25-12. However, if the share price is equal to or less than $12, Holder would be expected to put the shares back to Entity B and could choose to obligate Entity B to pay $12 in cash. That feature does result in a liability, because the financial instrument embodies an obligation to repurchase the issuer's shares and may require a transfer of assets. Therefore, those paragraphs require Entity B to classify the warrant as a liability. A warrant to issue shares that will be mandatorily redeemable is also classified as a liability, and should be analyzed under Topic 815.

While in the preceding example (1) the underlying shares are immediately puttable (2) for a fixed amount, ASC 480 requires liability treatment for freestanding warrants and other freestanding instruments that require the issuance of shares that are either puttable or mandatorily redeemable, regardless of whether the shares are immediately redeemable or are redeemable at a later date and regardless of whether the redemption price is fixed because those instruments embody obligations to transfer assets. Accordingly, ASC 480-10-25-8 applies to warrants on shares that are redeemable immediately after exercise of the warrants and also to those that are redeemable at some date in the future. This is consistent with guidance provided in FSP FAS 150-5 on paragraph 11 of Statement 150, which subsequently was codified in ASC 480-10-25-8.

> **Freestanding Warrants and Other Similar Instruments on Shares that Are Redeemable**
>
> A warrant for puttable shares conditionally obligates the issuer to ultimately transfer assets—the obligation is conditioned on the warrant's being exercised and the shares obtained by the warrant being put back to the issuer for cash or other assets. Similarly, a warrant for mandatorily redeemable shares also conditionally obligates the issuer to ultimately transfer assets—the obligation is conditioned only on the warrant's being exercised because the shares will be redeemed. Thus, warrants for both puttable and mandatorily redeemable shares are analyzed the same way and are liabilities under paragraphs 480-10-25-8 through 25-12, even though the number of conditions leading up to the possible transfer of assets differs for those warrants. The warrants are liabilities even if the share repurchase feature is conditional on a defined contingency.

The following example from ASC 480-10-55-18 to 55-20 illustrates how an instrument that contains both a written put option and purchased call option can be an asset or a liability at a given point in time.

> **Combination of Written Put Option and Purchased Call Option Issued as a Freestanding Instrument**
>
> If a freestanding financial instrument consists solely of a written put option to repurchase the issuer’s equity shares and another option, that freestanding financial instrument in its entirety is subjected to paragraphs 480-10-25-4 through 25-14 to determine if it meets the requirements to be classified as a liability.
>
> For example, an entity may enter into a contract that requires it to purchase 100 shares of its own stock on a specified date for $20 if the stock price falls below $20 and entitles the entity to purchase 100 shares on that date for $21 if the stock price is greater than $21. That contract shall be analyzed as the combination of a written put option and a purchased call option and not as a forward contract. The written put option on 100 shares has a strike price of $20, and the purchased call option on 100 shares has a strike price of

$21. If at issuance the fair value of the written put option exceeds the fair value of the purchased call option, the issuer receives cash and the contract is a net written option—a liability. If required to be physically settled, that contract is a liability under the provisions in paragraphs 480-10-25-8 through 25-12 because it embodies an obligation that may require repurchase of the issuer's equity shares and settlement by a transfer of assets. If the issuer must or can net cash settle the contract, the contract is a liability under the provisions of those paragraphs because it embodies an obligation that is indexed to an obligation to repurchase the issuer's equity shares and may require settlement by a transfer of assets. If the issuer must or can net share settle the contract, that contract is a liability under the provisions in paragraph 480-10-25-14(c), because the monetary value of the obligation varies inversely in relation to changes in the fair value of the issuer's equity shares.

If, in this example, the fair value of the purchased call option at issuance exceeds the fair value of the written put option, the issuer pays out cash and the contract is a net purchased option, to be initially classified as an asset under either paragraphs 480-10-25-8 through 25-12 or 480-10-25-14(c). If the fair values of the two options are equal and opposite at issuance, the financial instrument has an initial fair value of zero, and is commonly called a zero-cost collar. Thereafter, if the fair value of the instrument changes, the instrument is classified as an asset or a liability and measured subsequently at fair value.

5.2.1.2 Obligations to issue a variable number of shares

ASC 480-10-25-14 requires liability treatment (or asset in some circumstances) for a freestanding financial instrument that embodies a conditional or unconditional obligation that the issuer must or may settle by issuing a variable number of its equity shares if, at inception, the monetary value of the obligation is based solely or predominantly on any one of the following three criteria:

1. A fixed monetary amount known at inception (e.g., a payable settled with a variable number of the issuer's equity shares)
2. Variations in something other than the fair value of the issuer's equity shares (e.g., a financial instrument indexed to the Standard & Poor's S&P 500 index and settled with a variable number of the issuer's shares)
3. Variations inversely related to changes in the fair value of the issuer's equity shares (e.g., a written put option that could be net share settled)

Understanding the terminology

The following are key terms used in ASC 480-10, along with their definitions from the Master Glossary of the ASC:

- **Monetary value**: "What the fair value of the cash, shares, or other instruments that a financial instrument obligates the issuer to convey to the holder would be at the settlement date under specified market conditions."
- **Obligation**: "A conditional or unconditional duty or responsibility to transfer assets or to issue equity shares."

As is pointed out at ASC 480-10-55-26, forward purchase contracts and written put options that must or may be net share settled are examples of instruments that are liabilities due to the third criterion because as the issuer's share price decreases, the obligation to the issuer increases. (Note that those contracts that will be physically settled or net cash settled should be analyzed at Section 5.2.1.1.)

The analysis of whether a freestanding financial instrument is within the scope of ASC 480-10-25-14 becomes more complex when the monetary value is in part, but not solely, based on one of the three criteria and when the instrument in question has multiple components, some of which may be settled in a variable number of shares. Subjectivity comes into play in determining if the monetary value of the component obligation or obligations that meet the criteria of ASC 480-10-25-14 are predominant over all other component obligations such that liability classification is required due to this guidance in ASC 480.

This is in contrast to ASC 480-10-25-8 discussed at Section 5.2.1.1 whereby if any component obligates the issuer to repurchase shares (or is indexed to such an obligation) and may require a transfer of cash or other assets, no consideration is given to predominance and the instrument is classified as a liability (or an asset in some circumstances) in its entirety. The analysis is further complicated by the fact that predominantly is not defined in ASC 480. We are aware of divergent views in practice as to whether predominant should be interpreted as more likely than not or a higher threshold such as 90 percent as suggested by the use of the words “in small part” in ASC 480-10-55-22. As such, it is important for management to have a well-documented and thought-out interpretation of predominant that is consistently applied.

The following examples from ASC 480-10-55-42 to 55-52 may be useful in performing this analysis.

> **Certain Financial Instruments Involving Multiple Components that May Be Settled in a Variable Number of Shares**
>
> A financial instrument composed of more than one option or forward contract embodying obligations to issue shares must be analyzed to determine whether the obligations under any of its components have one of the characteristics in paragraph 480-10-25-14, and if so, whether those obligations are predominant relative to other obligations. For example, a puttable warrant that allows the holder to purchase a fixed number of the issuer's shares at a fixed price that also is puttable by the holder at a specified date for a fixed monetary amount to be paid, at the issuer's discretion, in cash or in a variable number of shares.
>
> [**RSM note**: If payment of the put price was required to be in cash, or would be in cash or shares at the holder’s discretion, the warrant would be a liability due to ASC 480-10-25-8 as elaborated on at Section 5.2.1.1.]
>
> The analysis can be summarized in two steps:
>
> a. Identify any component obligations that, if freestanding, would be liabilities under paragraph 480-10-25-14. Also identify the other component obligation(s) of the financial instrument.
>
> b. Assess whether the monetary value of any obligations embodied in components that, if freestanding, would be liabilities under paragraph 480-10-25-14 is (collectively) predominant over the (collective) monetary value of other component obligation(s). If so, account for the entire instrument under that paragraph. If not, the financial instrument is not in the scope of this Subtopic and other guidance applies.
>
> In an instrument that allows the holder either to purchase a fixed number of the issuer's shares at a fixed price or to compel the issuer to reacquire the instrument at a fixed date for shares equal to a fixed monetary amount known at inception, the holder's choice will depend on the issuer's share price at the settlement date. The issuer must analyze the instrument at inception and consider all possible outcomes to judge which obligation is predominant. To do so, the issuer considers all pertinent information as applicable, which may include its current stock price and volatility, the strike price of the instrument, and any other factors. If the issuer judges the obligation to issue a variable number of shares based on a fixed monetary amount known at inception to be predominant, the instrument is a liability under paragraph 480-10-25-14. Otherwise, the instrument is not a liability under this Subtopic but is subject to other applicable guidance such as Subtopic 815-40.
>
> **Warrant with Share-Settleable Puts**
>
> Entity C issues a puttable warrant to Holder. The warrant feature allows Holder to purchase 1 equity share at a strike price of $10 on a specified date. The put feature allows Holder instead to put the warrant back to Entity C on that date for $2, settleable in fractional shares. If the share price on the settlement date is greater than $12, Holder would be expected to exercise the warrant, obligating Entity C to issue a fixed number of shares in exchange for a fixed amount of cash; the monetary value of the shares varies directly with changes in the share price above $12. If the share price is equal to or less than $12, Holder would be expected to put the warrant back to Entity C obligating the entity to issue a variable number of shares with a fixed monetary value, known at inception, of $2. Thus, at inception, the number of shares that the

puttable warrant obligates Entity C to issue can vary, and the financial instrument must be examined under paragraph 480-10-25-14.

The facts and circumstances should be considered in judging whether the monetary value of the obligation to issue a number of shares that varies is predominantly based on a fixed monetary amount known at inception; if so, it is a liability under paragraph 480-10-25-14(a). For example, if the following circumstances existed, they would suggest that the monetary value of the obligation to issue shares would be judged to be based predominantly on a fixed monetary amount known at inception ($2 worth of shares), and the instrument would be classified as a liability:

a. Entity C's share price is well below the $10 exercise price of the warrant at inception of the instrument.

b. The warrant has a short life

c. Entity C's stock is determined to have very low volatility.

Entity E issues a warrant to Holder allowing Holder to purchase 1 equity share at a strike price of $10. The warrant has an embedded liquidity make-whole put that entitles Holder to receive from Entity E the net amount of any difference between the share price on the date the warrants are exercised and the sales price the holder receives when the shares are later sold. The make-whole provision is not legally detachable. Entity E can settle by issuing a variable number of shares. For example, if on the date Holder exercises the warrant, the share price is $15 and the share price subsequently decreases to $12 at the date Holder sells the shares, Holder would receive $3 worth of equity shares from Entity E.

The financial instrument embodies an obligation to deliver a number of shares that varies-either a fixed number of shares under exercise of the warrant or additional shares if the share price declines after the warrant is exercised. However, unless it is judged that the possibility of having to issue a variable number of shares with a monetary value that is inversely related to the share price is predominant, the financial instrument is not in the scope of paragraph 480-10-25-14(c) and would be evaluated under Subtopic 815-40.

If exercisability of a feature into a fixed or variable number of shares is contingent on both the occurrence or nonoccurrence of a specified event and the issuer's share price, a financial instrument settleable in a number of shares that can vary should be analyzed following the same method as for the examples in paragraphs 480–10–55–45 and 480-10-55-50 to consider all possibilities. In some cases, it may be determined that the instrument may not be within the scope of paragraph 480-10-25-14 and thus not a liability under this Subtopic. That determination depends on whether the obligation to deliver a variable number of shares, with a monetary value based on either a fixed monetary amount known at inception or an inverse relationship with the share price, is predominant at inception.

Variable Share Forward Sales Contract

Entity D enters into a contract to issue shares of Entity D's stock to Counterparty in exchange for $50 on a specified date. If Entity D's share price is equal to or less than $50 on the settlement date, Entity D will issue 1 share to Counterparty. If the share price is greater than $50 but equal to or less than $60, Entity D will issue $50 worth of fractional shares to Counterparty. Finally, if the share price is greater than $60, Entity D will issue .833 shares. At inception, the share price is $49. Entity D has an obligation to issue a number of shares that can vary; therefore, paragraph 480-10-25-14 may apply. However, unless it is determined that the monetary value of the obligation to issue a variable number of shares is predominantly based on a fixed monetary amount known at inception (as it is in the $50 to $60 share price range), the financial instrument is not in the scope of this Subtopic.

Some financial instruments that are composed of more than one option or forward contract embody an obligation to issue a fixed number of shares and, once those shares are issued, potentially to issue a variable number of additional shares. The issuer must analyze that kind of financial instrument, at inception, to assess whether the possibility of issuing a variable number of shares in which the monetary value of that obligation meets one of the conditions in paragraph 480-10-25-14 is predominant.

Contingently Puttable Warrant

Entity F has a share-settleable puttable warrant that provides that the put feature is exercisable only if Entity F fails to accomplish an operational plan (for example, failure to complete a building within two years). If at inception the possibility that both the building will not be completed in two years and the put will be exercised is judged to be predominant, the put warrant would be recognized as a liability under paragraph 480-10-25-14(a).

[**RSM note:** If payment of the put price was required to be in cash or could be in cash at the holder's discretion, the warrant would be a liability due to ASC 480-10-25-8 as elaborated on at Section 5.2.1.1.]

5.2.1.3 Initial and subsequent measurement of instruments subject to ASC 480

ASC 480-10-30 and ASC 480-10-35, respectively, address the initial and subsequent measurement of freestanding financial instrument contracts that are subject to the scope of ASC 480. With the exception of physically settled forward contracts discussed later in this section, freestanding equity-linked instruments that are subject to ASC 480 are initially measured at fair value. The following should be considered in determining the subsequent measurement of such instruments subject to the scope of ASC 480:

- Consideration should be given to whether the instrument is within the scope of ASC 815, because if so, it would be subsequently measured in accordance with ASC 815, generally at fair value with changes in fair value recognized in earnings, and subject to the disclosure requirements of ASC 815.
- Specific guidance follows for forward contracts that require physical settlement in exchange for cash.

All other instruments (including forward purchase contracts that: [a] require or permit net cash settlement, [b] require or permit net share settlement or [c] require physical settlement in exchange for specified quantities of assets other than cash) should be measured subsequently at fair value with changes in fair value recognized in earnings, unless a different subtopic specifies another measurement attribute.

5.2.1.3.1 Certain physically settled forward purchase contracts. As outlined beginning at ASC 480-10-30-3, forward contracts that require physical settlement by repurchase of a fixed number of the issuer's shares in exchange for cash are measured initially at the fair value of the shares at inception, adjusted as necessary for any consideration or unstated rights and privileges. The fair value of the shares can be obtained using one of the following two approaches:

- By determining the amount of cash that would be paid under the conditions specified in the contract if the shares were repurchased immediately
- By discounting the settlement amount at the rate implicit at inception

The initial liability for these contracts is established by reducing equity by an amount equal to the fair value of the shares at inception. The contracts are subsequently measured as follows in accordance with ASC 480-10-35-3:

- At the present value of the amount to be paid at settlement, accruing interest cost using the rate implicit at inception, if both the amount to be paid and the settlement date are fixed
- At the amount of cash that would be paid under the conditions specified in the contract if settlement occurred at the reporting date, recognizing the resulting change in that amount from the previous reporting date as interest cost if either the amount to be paid or the settlement date varies based on specified conditions

The following example from ASC 480-10-55-14 to 55-16 illustrates the initial and subsequent measurement for forward contracts that require physical settlement.

Physically Settled Forward Purchase Contract

For example, an entity may enter into a forward contract to repurchase 1 million shares of its common stock from another party 2 years later. At inception, the forward contract price per share is $30, and the current price of the underlying shares is $25. The contract's terms require that the entity pay cash to repurchase the shares (the entity is obligated to transfer $30 million in 2 years). Because the instrument embodies an unconditional obligation to transfer assets, it is a liability under paragraphs 480-10-25-8 through 25-12. The entity would recognize a liability and reduce equity by $25 million (which is the present value, at the 9.54 percent rate implicit in the contract, of the $30 million contract amount, and also, in this example, the fair value of the underlying shares at inception). Interest would be accrued over the 2-year period to the forward contract amount of $30 million, using the 9.54 percent rate implicit in the contract. If the underlying shares are expected to pay dividends before the repurchase date and that fact is reflected in the rate implicit in the contract, the present value of the liability and subsequent accrual to the contract amount would reflect that implicit rate. Amounts accrued are recognized as interest cost.

In this example, no consideration or other rights or privileges changed hands at inception. If the same contract price of $30 per share had been agreed to even though the current price of the issuer's shares was $30, because the issuer had simultaneously sold the counterparty a product at a $5 million discount, that right or privilege unstated in the forward purchase contract would be taken into consideration in arriving at the appropriate implied discount rate—9.54 percent rather than 0 percent—for that contract. That entity would recognize a liability for $25 million, reduce equity by $30 million, and increase its revenue for the sale of the product by $5 million. Alternatively, if the same contract price of $30 per share had been agreed to even though the current price of the issuer's shares was only $20, because the issuer received a $5 million payment at inception of the contract, the issuer would recognize a liability for $25 million and reduce equity by $20 million. In both examples, interest would be accrued over the 2-year period using the 9.54 percent implicit rate, increasing the liability to the $30 million contract price.

If a variable-rate forward contract requires physical settlement, a different measurement method is required subsequently, as set forth in paragraph 480-10-35-3.

5.2.2 ASC 815 considerations

Subtopics within ASC 815 that are relevant in determining the appropriate balance sheet classification and measurement for an equity-linked instrument or embedded feature include:

- ASC 815-10 to determine whether the instrument or feature in question is a derivative within the scope of ASC 815 (refer to Section 5.2.2.3 of this guide)
- ASC 815-15 to determine whether an embedded feature requires separate recognition as a derivative (for derivatives embedded in debt refer to Section 2.3 or Section 3.3, as applicable, and for derivatives embedded in preferred and similar stock, refer to Section 4.3)
- ASC 815-40 to determine if the equity-linked instrument or feature is indexed to the entity's own stock and classified in equity (discussion follows)

5.2.2.1 Determining if the instrument is indexed to the entity's own stock

The guidance relevant to this determination is contained within ASC 815-40-15 (the related implementation guidance is contained in ASC 815-40-55) and should be considered for the following:

- Freestanding financial instruments that are potentially settled in the entity's own stock and not within the scope of ASC 480 (regardless of whether the instrument has all the characteristics of a derivative) to determine the balance sheet classification
- Equity-linked embedded features that are derivatives that are not clearly and closely related to the host contract to determine if the feature qualifies for the scope exclusion at ASC 815-10-15-74(a) for contracts that are both: (a) indexed to the entity's own stock (addressed in the paragraphs that follow) and (b) classified in stockholders' equity in its balance sheet (addressed at Section 5.2.2.2)

ASC 815-40-15-7 outlines a two-step approach for determining whether an instrument is indexed to an entity's own stock. The first step is to evaluate the instrument's contingent exercise provisions, if any, and the second step is to evaluate the instrument's settlement provisions. To be considered indexed to the entity's own stock, the instrument must pass both steps in this process.

5.2.2.1.1 Step 1: Evaluate contingent exercise provisions. An exercise contingency is defined in the Master Glossary of the ASC as follows:

> A provision that entitles the entity (or the counterparty) to exercise an equity-linked instrument (or embedded feature) based on changes in an underlying, including the occurrence (or nonoccurrence) of a specified event. Provisions that accelerate the timing of the entity's (or the counterparty's) ability to exercise an instrument and provisions that extend the length of time that an instrument is exercisable are examples of exercise contingencies, as well as provisions that make the instrument exercisable.

Common provisions include those that allow either party to exercise the instrument upon reaching a certain level of sales or upon the completion of an IPO.

Exercise contingencies would not preclude an instrument (or embedded feature) from being considered indexed to an entity's own stock under ASC 815-40-15-7A unless they are based on an observable market other than the market for the issuer's stock or are based on an observable index other than an index calculated or measured solely by reference to the issuer's own operations, such as sales; earnings before interest, taxes, depreciation and amortization; net income or total equity of the issuer.

Examples of exercise contingencies

The following exercise contingencies are illustrated in three distinct examples in ASC 815-40-55-26 to 55-28, in which Entity A issues a warrant that becomes exercisable:

1. If it completes an IPO
2. When it attains cumulative total sales of $100 million
3. If the Standard & Poor's S&P 500 index increases 500 points within any given calendar year

The first two are examples of exercise contingencies that do not preclude the warrant from being indexed to Entity A's stock. However, in the third example, the warrant is not indexed to Entity A's stock given that the exercise contingency is based on an observable index unrelated to Entity A's own operations.

5.2.2.1.2 Step 2: Evaluate the instrument's settlement provisions

If the evaluation of Step 1 does not preclude an instrument from being considered indexed to the entity's own stock, consideration is next given to the instrument's settlement provisions. For an instrument to be considered indexed to an entity's own stock, as is pointed out at ASC 815-40-15-7C, the settlement amount needs to equal the difference between the fair value of a fixed number of the entity's equity shares and a fixed monetary amount or a fixed amount of a debt instrument issued by the entity. An example follows.

Example: An instrument with fixed settlement terms

Company A issues an instrument with the following terms:

- The holder of the instrument can purchase 10 shares of Company A's stock for $15 per share.
- The instrument will expire five years from the date of issuance and is exercisable at any time.

Assume that there are no contractual provisions that could change these terms and that the fair value of the stock on the date of exercise is $25 per share.

In this example, the settlement amount is $100, or the difference between the fair value of $250 (10 shares x $25 per share fair value at the date of exercise) and the fixed exercise price of $150 ($15 per share exercise price x 10 shares). Because both the exercise price ($15) and the number of shares (10) are fixed, this instrument would meet the settlement provisions criteria to be indexed to the entity's own stock.

In reality, instruments are rarely this simple as they commonly provide for potential adjustments to either the strike price ($15 in the previous example) or the number of shares to be issued (10 shares in the previous example) if certain circumstances occur. Therefore, these adjustment provisions must be analyzed under ASC 815-40 regardless of the probability of such adjustments occurring or whether such adjustments are within the entity's control.

As is stated in ASC 815-40-15-7D, an instrument (or embedded feature) with potential adjustments would still be considered indexed to an entity's own stock if the only variables that could affect the settlement amount would be inputs to the fair value calculation of a fixed-for-fixed forward or option on equity shares. The most widely known fixed-for-fixed fair value option model is the Black-Scholes-Merton model. As stated at ASC 815-40-15-7E, inputs to such calculations generally include the entity's stock price, as well as the following types of variables:

- Strike price
- Term of the instrument
- Expected dividends or other dilutive activities
- Stock borrow cost
- Interest rates
- Stock price volatility
- The entity's credit spread
- The ability to maintain a standard hedge position in the underlying shares

As discussed at ASC 815-40-15-7E, determinations and adjustments related to the settlement amount (including the determination of the ability to maintain a standard hedge position) must be commercially reasonable. An instrument (or embedded feature) would not be considered indexed to the entity's own stock if its settlement amount is affected by variables that are extraneous to the pricing of a fixed-for-fixed option or forward contract on equity shares, or if the instrument contains a feature (such as a leverage factor) that increases exposure to the additional variables listed earlier in a manner that is inconsistent with a fixed-for-fixed forward or option on equity shares.

Standard pricing models for equity-linked financial instruments contain certain implicit assumptions. One such assumption is that the stock price exposure inherent in those instruments can be hedged by entering into an offsetting position in the underlying equity shares. For example, the Black-Scholes-Merton option-pricing model assumes that the underlying shares can be sold short without transaction costs and that stock price changes will be continuous. Accordingly, for purposes of applying Step 2, fair value inputs include adjustments to neutralize the effects of events that can cause stock price discontinuities. For example, a merger announcement may cause an immediate jump (up or down) in the price of shares underlying an equity-linked option contract. A holder of that instrument would not be able to continuously adjust its hedge position in the underlying shares due to the discontinuous stock price change. As a result, changes in the fair value of an equity-linked instrument and the fair value of an offsetting hedge position in the underlying shares will differ, creating a gain or loss for the instrument holder as a result of the merger announcement. Therefore, as is reinforced at ASC 815-40-15-7G, inclusion of provisions that adjust the terms of the instrument to offset the net gain or loss resulting from a

merger announcement or similar event do not preclude an equity-linked instrument (or embedded feature) from being considered indexed to an entity's own stock.

ASC 815-40-15-7H acknowledges that some equity-linked financial instruments give the issuer the unilateral ability to modify the terms of the instrument at any time. If this ability is limited to modifications that would be for the benefit of the counterparty, such as modifications to induce exercise, such a provision would not affect the determination of whether the instrument (or embedded feature) is considered indexed to the entity's own stock.

If the strike price of an equity-linked financial instrument is denominated in a currency that is not the functional currency of the issuer, as is pointed out at ASC 815-40-15-7I, the instrument (or embedded feature) is not considered to be indexed to the entity's own stock, regardless of the currency (or currencies) in which the underlying shares trade.

As indicated at ASC 815-40-15-5C, freestanding financial instruments (and embedded features) for which the payoff to the counterparty is based, in whole or in part, on the stock of a consolidated subsidiary are not precluded from being considered indexed to the entity's own stock in the consolidated financial statements of the parent if the subsidiary is a substantive entity. If the subsidiary is not a substantive entity, the instrument or embedded feature would not be considered indexed to the entity's own stock.

5.2.2.1.3 Comprehensive examples. The following examples illustrate the application of the guidance relevant to determining whether an instrument (or embedded feature) is indexed to an entity's own stock.

Adjustments to the number of shares based on a percentage of fully diluted shares outstanding

Rather than a fixed number of shares, an instrument (or an embedded feature) may require settlement in a variable number of shares based on a stated percentage of the entity's outstanding stock. For example, a warrant may provide the holder with the right to acquire 3% of the entity's outstanding shares at the time of exercise. In this scenario, the number of shares varies based on any subsequent issuances or redemptions of the entity's stock. As changes in the number of shares outstanding will cause the settlement amount to vary and is not an input to the fair value of a fixed-for-fixed option pricing model, the instrument or embedded feature would not be considered indexed to the entity's own stock.

Adjustments triggered by contractual changes to the strike price of another instrument

Upon the adoption of ASU 2017-11, down round features are excluded when determining whether an instrument is indexed to the entity's stock. It is our understanding through discussions with the FASB staff that the definition of a down round is intended to be strictly applied. We have observed numerous agreements in practice that provide for adjustments to the strike price of an instrument that are similar to a down round but provide for protection that extends beyond a down round feature as defined. An example includes an adjustment that is triggered by contractual changes to the strike price of another instrument. The definition of a down round and the illustration at Example 9 in ASC 815-40-55 provide for reductions to the strike price when the issuer sells or issues shares at a lower price and do not extend to changes to the strike price of another instrument. Since changes to the strike price of another instrument are not an input to the fair value of a fixed-for-fixed option pricing model, an instrument or embedded feature that has an adjustment provision that could be triggered by contractual changes to the strike price of another instrument would not be considered indexed to the entity's own stock.

Changes to settlement amount based on the holder of the instrument

On April 12, 2021, the SEC issued a Staff Statement on Accounting and Reporting Considerations for Warrants Issued by Special Purpose Acquisition Companies ("SPACs"), which highlighted a number of important financial reporting considerations for SPACs. Most notably, the statement describes fact patterns that are common in warrants issued in connection with a SPAC's formation and initial registered offering.

One of the fact patterns highlighted related to warrants that include provisions that provide for potential changes to the settlement amounts dependent upon who the holder of the warrant is. These provisions often exist in the context of private placement warrants issued to the SPAC sponsor or its affiliates, whereby settlement amounts or adjustments to the terms of the warrants may differ depending on whether the sponsor continues to hold the warrants. While less common, certain public warrants issued by SPACs have settlement amounts or adjustments to the terms that differ if the warrants are held by executives or directors. Because the holder of the instrument is not an input to the fair value of a fixed-for-fixed option pricing model, the warrants are precluded from being indexed to the entity's stock.

Share-settled earn-out arrangements

Entities sometimes enter into arrangements in conjunction with mergers that require them to issue shares at a future date if the company's stock price exceeds a certain threshold. For example, SPACs may enter into these arrangements with their sponsors or with the target's shareholders. Sometimes, rather than the arrangements requiring additional shares to be issued at a future date, the arrangements may provide for certain shares to be forfeited if stock price levels or other conditions are not met. Generally the guidance discussed within this chapter, including the guidance in this section on determining whether the instrument is indexed to the entity's stock, should be applied to both arrangements that obligate the entity to issue shares as well as those that could result in the forfeiture of shares unless the arrangement is within the scope of ASC 718. If the arrangement provides solely for a fixed number of shares (e.g., one million) to be issued upon the occurrence of a certain stock price threshold being met and (or) the occurrence of a certain event taking place (e.g., a business combination), it likely would meet the indexation requirements for equity classification, given that (a) if shares are issued, the number is fixed at one million shares and (b) the exercise contingency that determines whether the shares are issued is based on the entity's stock price or occurrence of a business combination, neither of which are inconsistent with the indexation requirements for exercise contingencies. In many cases, earn-out arrangements are structured in a manner that could result in differing amounts of shares being issued. An example of this is an arrangement whereby (a) if the stock price reaches $15 within a pre-defined period, one million shares will be issued, and (b) if the stock price reaches $30 within the pre-defined period, an additional one million shares will be issued. Since an entity's stock price is an input to an option pricing model, variability that is solely attributable to the entity's stock price is not inconsistent with the indexation requirements; however, if the full two million shares would become issuable upon the occurrence of an event, such as a change in control, the arrangement would not be indexed to the entity's stock because a change in control would change the settlement amount and is not an input to an option pricing model. (The settlement amount may be zero shares, one million shares or two million shares, and this variability is due in part to the occurrence of a change in control).

The examples that follow are contained within ASC 815-40-55-26 to 55-47.

> *Example 2: Variability Involving Completion of an Initial Public Offering*
>
> Entity A issues warrants that permit the holder to buy 100 shares of its common stock for $10 per share. The warrants have 10-year terms; however, they only become exercisable if Entity A completes an initial public offering. The warrants are considered indexed to Entity A's own stock based on the following evaluation:
>
> a. Step 1. The exercise contingency (that is, the initial public offering) is not an observable market or an observable index, so the evaluation of Step 1 does not preclude the warrants from being considered indexed to the entity's own stock. Proceed to Step 2.
>
> b. Upon exercise, the settlement amount would equal the difference between the fair value of a fixed number of the entity's equity shares (100 shares) and a fixed strike price ($10 per share).
>
> *Example 3: Variability Involving Sales Volume*
>
> Entity A issues warrants that permit the holder to buy 100 shares of its common stock for $10 per share. The warrants have 10-year terms; however, they only become exercisable after Entity A accumulates $100

million in sales to third parties. The warrants are considered indexed to Entity A's own stock based on the following evaluation:

a. Step 1. The exercise contingency (that is, the accumulation of $100 million in sales to third parties) is an observable index. However, it can only be calculated or measured by reference to Entity A's sales, so the evaluation of Step 1 does not preclude the warrants from being considered indexed to the entity's own stock. Proceed to Step 2.

b. Step 2. Upon exercise, the settlement amount would equal the difference between the fair value of a fixed number of the entity's equity shares (100 shares) and a fixed strike price ($10 per share).

Example 4: Variability Involving Stock Index

Entity A issues warrants that permit the holder to buy 100 shares of its common stock for $10 per share. The warrants have 10-year terms; however, they only become exercisable if the Standard & Poor's S&P 500 Index increases 500 points within any given calendar year during that 10-year period. The warrants are not considered indexed to Entity A's own stock based on the following evaluation:

a. Step 1. The exercise contingency (that is, the increase of 500 points in Standard& Poor's S&P 500 Index) is based on an observable index that is not measured solely by reference to the issuer's own operations.

b. Step 2. It is not necessary to evaluate Step 2.

Example 5: Variability Involving a Commodity Price

Entity A issues warrants that permit the holder to buy 100 shares of its common stock in exchange for one ounce of gold. The warrants have 10-year terms; however, they only become exercisable if Entity A completes an initial public offering. The warrants are not considered indexed to Entity A's own stock based on the following evaluation:

a. Step 1. The exercise contingency (that is, the initial public offering) is not an observable market or an observable index, so the evaluation of Step 1 does not preclude the warrants from being considered indexed to the entity's own stock. Proceed to Step 2.

b. Step 2. The settlement amount would not equal the difference between the fair value of a fixed number of the entity's equity shares (100 shares) and a fixed strike price. Although the number of shares that would be issued at settlement is fixed, the strike price varies based on the price of one ounce of gold. The price of gold is not an input to the fair value of a fixed-for-fixed option on equity shares.

Example 6: Variability Involving Merger Announcement

Entity A issues warrants that permit the holder to buy 100 shares of its common stock for $10 per share. The warrants have 10-year terms and are exercisable at any time. However, the terms of the warrants specify that if there is an announcement of a merger involving Entity A, the strike price of the warrants will be adjusted to offset the effect of the merger announcement on the net change in the fair value of the warrants and of an offsetting hedge position in the underlying shares. The strike price adjustment must be determined using commercially reasonable means based on an assumption that the counterparty has entered into a hedge position in the underlying shares to offset the share price exposure from the warrants. That strike price adjustment is not affected by the counterparty's actual hedging position (for example, the strike price adjustment does not differ in circumstances when the counterparty is over-hedged or under-hedged). The warrants are considered indexed to Entity A's own stock based on the following evaluation:

a. Step 1. The instruments do not contain an exercise contingency. Proceed to Step 2.

b. Step 2. The settlement amount would equal the difference between the fair value of a fixed number of the entity's equity shares (100 shares) and a fixed strike price ($10 per share), unless there is a merger announcement. If there is a merger announcement, the settlement amount would be adjusted to offset the effect of the merger announcement on the fair value of the warrants. In that circumstance, the only variables that could affect the settlement amount would be inputs to the fair value of a fixed-

for-fixed option on equity shares. For further discussion, see paragraphs 815-40-15-7E and 815-40-15-7G.

Example 7: Variability Involving Revenue Target

Entity A issues warrants that permit the holder to buy 100 shares of its common stock for an initial price of $10 per share. The warrants have 10-year terms and are exercisable at any time. However, the terms of the warrants specify that the strike price is reduced by $0.50 after any year in which Entity A does not achieve revenues of at least $100 million. The warrants are not considered indexed to Entity A's own stock based on the following evaluation:

a. Step 1. The instruments do not contain an exercise contingency. Proceed to Step 2.

b. Step 2. The settlement amount would not equal the difference between the fair value of a fixed number of the entity's equity shares (100 shares) and a fixed strike price. Although the number of shares that would be issued at settlement is fixed, the strike price would be adjusted after any year in which Entity A does not achieve revenues of at least $100 million. The amount of an entity's annual revenues is not an input to the fair value of a fixed-for-fixed option on equity shares.

Example 8: Variability Involving Stock Price Cap

Entity A purchases net-settled call options that permit it to buy 100 shares of its common stock for $10 per share. However, the maximum appreciation on the call options is capped when Entity A's stock price reaches $15 per share (that is, the counterparty's maximum obligation is $500 [($15− $10) x 100 shares]). The call options have 10-year terms and are exercisable at any time. The call options are considered indexed to Entity A's own stock based on the following evaluation:

a. Step 1. The instruments do not contain an exercise contingency. Proceed to Step 2.

b. Step 2. The settlement amount would equal the difference between the fair value of a fixed number of the entity's equity shares (100 shares) and a fixed strike price when Entity A's stock price is between the $10 stated exercise price and the $15 price cap. However, whenever Entity A's stock price exceeds $15, the strike price of the call options increases and decreases in amounts equal to the corresponding increases and decreases in Entity A's stock price, such that the intrinsic value of each call option always equals $5. Because the only variable that can affect the settlement amount is the entity's stock price, which is an input to the fair value of a fixed-for-fixed option contract, the call options are considered indexed to the entity's own stock.

Example 9: Variability Involving Future Equity Offerings and Issuance of Equity-Linked Financial Instruments

This Example illustrates the application of the guidance beginning in paragraph 815-40-15-5 for a financial instrument that includes a down round feature.Entity A issues warrants that permit the holder to buy 100 shares of its common stock for $10 per share. The warrants have 10-year terms and are exercisable at any time. However, the terms of the warrants specify both of the following:

a. If the entity sells shares of its common stock for an amount less than $10 per share, the strike price of the warrants is reduced to equal the issuance price of those shares.

b. If the entity issues an equity-linked financial instrument with a strike price below $10 per share, the strike price of the warrants is reduced to equal the strike price of the newly issued equity-linked financial instrument.

The warrants are considered indexed to Entity A's own stock based on the following evaluation:

a. Step 1. The instruments do not contain an exercise contingency. Proceed to Step 2.

b. Step 2. In accordance with paragraph 815-40-15-5D, when classifying a financial instrument with a down round feature, an entity shall exclude that feature when considering whether the instrument is indexed to the entity’s own stock for the purposes of applying paragraphs 815-40-15-7C through 15-7I (Step 2). The instrument does not contain any other features to be assessed under Step 2.

See paragraph 260-10-45-12B for earnings-per-share considerations, paragraph 260-10-25-1 for recognition considerations, and paragraphs 505-10-50-3 through 50-3A for disclosure considerations. **RSM note**: Prior to the adoption of ASU 2017-11, down round features were required to be considered and precluded an instrument or embedded feature from being indexed to the entity's own stock. Refer to Appendix D for additional information on ASU 2017-11.]

Example 10: Variability Involving Regulatory Approval

Entity A issues warrants that permit the holder to buy 100 shares of its common stock for $10 per share. The warrants have 10-year terms and are exercisable at any time. However, the terms of the warrants specify that if Entity A does not obtain regulatory approval of a particular drug compound within 5 years, the holder can surrender the warrants to Entity A for $2 per warrant (settleable in shares). The contingently puttable warrants are not considered indexed to Entity A's own stock based on the following evaluation:

a. Step 1. The instruments do not contain an exercise contingency. Proceed to Step 2.

b. Step 2. The settlement amount would equal the difference between the fair value of a fixed number of the entity's equity shares (100 shares) and a fixed strike price ($10 per share), unless regulatory approval of a particular drug compound is not obtained within 5 years. If that approval is not obtained within the allotted time period, the holder could elect to surrender the warrants to Entity A in exchange for $2 per warrant. The contingent obligation to settle the warrants by transferring consideration with a fixed monetary value if regulatory approval of a particular drug compound is not obtained within a specified time period does not represent an input to the fair value of a fixed-for-fixed option on equity shares. A freestanding equity-linked instrument that provides for a fixed payoff upon the occurrence of a contingent event which is not based on the issuer's share price is not indexed to an entity's own stock.

Example 11: Variability Involving a Currency Other Than the Entity's Functional Currency

Entity A, whose functional currency is U.S. dollars (USD), issues warrants with a strike price denominated in Canadian dollars (CAD). The warrants permit the holder to buy 100 shares of its common stock for CAD 10 per share. Entity A's shares trade on an exchange on which trades are denominated in CAD. The warrants have 10-year terms and are exercisable at any time. The warrants are not considered indexed to Entity A's own stock based on the following evaluation:

a. Step 1. The instruments do not contain an exercise contingency. Proceed to Step 2.

b. Step 2. The strike price of the warrants is denominated in a currency other than the entity's functional currency, so the warrants are not considered indexed to the entity's own stock.

Example 12: Variability Involving Dividend Distributions

Entity A enters into a forward contract to sell 100 shares of its common stock for $10 per share in 1 year. Historically, Entity A has paid a dividend of $0.10 per quarter on its common shares. Under the terms of the forward contract, if dividends per common share differ from $0.10 during any 3-month period, the strike price of the forward contract will be adjusted to offset the effect of the dividend differential (actual dividend versus $0.10) on the fair value of the instrument. Additionally, the terms of the forward contract provide for an adjustment to the strike price, using commercially reasonable means, to offset the effect of any increased cost of borrowing Entity A's shares in the stock loan market on the fair value of the instrument. The forward contract is considered indexed to Entity A's own stock based on the following evaluation:

a. Step 1. The instrument does not contain an exercise contingency. Proceed to Step 2.

b. Step 2. The only circumstances in which the settlement amount will not equal the difference between the fair value of 100 shares and $1,000 ($10 per share) are if dividends per common share differ from $0.10 during any 3-month period or if there is an increased cost of borrowing Entity A's shares in the stock loan market. The adjustments to the strike price resulting from those events are intended to offset their effects on the instrument's fair value. In those circumstances, the only variables that could affect the settlement amount (dividends and stock borrow cost) would be inputs to the fair value of a fixed-for-fixed forward contract on equity shares.

Example 13: Variability Involving Average Stock Price

Entity A enters into a net-settleable forward contract to sell 100 shares of its common stock in 1 year for an amount equal to $10 per share plus interest calculated at a variable interest rate (Federal Funds rate plus a fixed spread). The share price used to determine the settlement amount is based on the volume-weighted average daily market price of Entity A's common stock for the 30-day period before the settlement date. The forward contract is considered indexed to Entity A's own stock based on the following evaluation:

a. Step 1. The instrument does not contain an exercise contingency. Proceed to Step 2.

b. Step 2. The settlement amount will not equal the difference between the fair value of a fixed number of the entity's equity shares (100 shares) and a fixed strike price. However, the only variables that cause the settlement amount to differ from a fixed-for-fixed settlement amount are the 30-day volume-weighted average daily market price of Entity A's common stock and an interest rate index. The pricing inputs of a fixed-for-fixed forward contract include the entity's stock price and interest rates. Additionally, the floating interest rate feature does not introduce a leverage factor or otherwise increase the effects of interest rate changes on the instrument's fair value.

Example 14: Variability Involving Interest Rate Index

Entity A enters into a forward contract to sell 100 shares of its common stock in 1 year for an amount equal to $10 per share plus interest calculated at a variable interest rate that varies inversely with changes in the London Interbank Offered Rate (LIBOR) (similar to an "inverse floater," as described in paragraphs 815-15-55-170 through 55-172). The forward contract is not considered indexed to Entity A's own stock based on the following evaluation:

a. Step 1. The instrument does not contain an exercise contingency. Proceed to Step 2.

b. Step 2. The settlement amount will not equal the difference between the fair value of a fixed number of the entity's equity shares (100 shares) and a fixed strike price. Although the number of shares that would be issued at settlement is fixed, the strike price varies inversely with changes in an interest rate index. The inverse floating interest rate feature increases the effects of interest rate changes on the instrument's fair value (that is, the feature increases the instrument's fair value exposure to interest rate changes) when compared to the exposure to interest rate changes of a fixed-for-fixed forward contract.

Example 15: Variability Involving Stock Price Cap and Floor

Entity A enters into a net-settled forward contract to sell 100 shares of its common stock in 1 year for $1,000. However, the maximum amount payable to the counterparty at maturity is capped when Entity A's stock price is greater than or equal to $15 per share (that is, Entity A's maximum obligation is $500 [($15− $10) x 100 shares]). Additionally, the maximum amount receivable from the counterparty at maturity is capped when Entity A's stock price is less than or equal to $5 per share (that is, the counterparty's maximum obligation is $500 [($5− $10) x 100 shares]). The forward contract is considered indexed to Entity A's own stock based on the following evaluation:

a. Step 1. The instrument does not contain an exercise contingency. Proceed to Step 2.

b. Step 2. The settlement amount would equal the difference between the fair value of a fixed number of the entity's equity shares (100 shares) and a fixed strike price ($1,000) when Entity A's stock price is between $5 and $15. However, whenever Entity A's stock price is greater than or equal to $15 at maturity, the amount payable to the counterparty always equals $500. Additionally, whenever Entity A's stock price is less than or equal to $5 at maturity, the amount receivable from the counterparty always equals $500. Because the only variable that can affect the settlement amount is the entity's stock price, which is an input to the fair value of a fixed-for-fixed forward contract, the instrument is considered indexed to the entity's own stock.

Example 16: Variability Involving Cap on Shares Issued

Entity A enters into a forward contract to sell a variable number of its common shares in 1 year for $1,000. If Entity A's stock price is equal to or less than $10 at maturity, Entity A will issue 100 shares of its

common stock to the counterparty. If Entity A's stock price is greater than $10 but equal to or less than $12 at maturity, Entity A will issue a variable number of its common shares worth $1,000. Finally, if the share price is greater than $12 at maturity, Entity A will issue 83.33 shares of its common stock. The forward contract is considered indexed to Entity A's own stock based on the following evaluation:

a. Step 1. The instrument does not contain an exercise contingency. Proceed to Step 2.

b. Step 2. The settlement amount will not equal the difference between the fair value of a fixed number of the entity's equity shares and a fixed strike price ($1,000). Although the strike price to be received at settlement is fixed, the number of shares to be issued to the counterparty varies based on the entity's stock price on the settlement date. Because the only variable that can affect the settlement amount is the entity's stock price, which is an input to the fair value of a fixed-for-fixed forward contract on equity shares, the instrument is considered indexed to the entity's own stock.

Example 17: Variability Involving Various Underlyings

Entity A enters into a forward contract to sell 100 shares of its common stock for $10 per share in 1 year. Under the terms of the forward contract, the strike price of the forward contract would be adjusted to offset the resulting dilution (except for issuances and repurchases that occur upon settlement of outstanding option or forward contracts on equity shares) if Entity A does any of the following:

a. Distributes a stock dividend or ordinary cash dividend

b. Executes a stock split, spinoff, rights offering, or recapitalization through a large, nonrecurring cash dividend

c. Issues shares for an amount below the then-current market price

d. Repurchases shares for an amount above the then-current market price.

The contractual terms that adjust the forward contract's strike price are eliminating the dilution to the forward contract counterparty that would otherwise result from the occurrence of those specified dilutive events. The adjustment to the strike price of the forward contract is based on a mathematical calculation that determines the direct effect that the occurrence of such dilutive events should have on the price of the underlying shares; it does not adjust for the actual change in the market price of the underlying shares upon the occurrence of those events, which may increase or decrease for other reasons.

The forward contract is considered indexed to Entity A's own stock based on the following evaluation:

a. Step 1. The instrument does not contain an exercise contingency. Proceed to Step 2.

b. Step 2. The only circumstances in which the settlement amount will not equal the difference between the fair value of 100 shares and $1,000 ($10 per share) are upon the occurrence of any of the following:

    1. The distribution of a stock dividend or ordinary cash dividend

    2. The execution of a stock split, spinoff, rights offering, or recapitalization through a large, nonrecurring cash dividend

    3. The issuance of shares for an amount below the then-current market price

    4. The repurchase of shares for an amount above the then-current market price.

An implicit assumption in standard pricing models for equity-linked financial instruments is that such events will not occur (or that the strike price of the instrument will be adjusted to offset the dilution caused by such events). Therefore, the only variables that could affect the settlement amount in this example would be inputs to the fair value of a fixed-for-fixed option on equity shares.

Example 18: Variability Involving Forward Contract Settled in a Currency Other Than the Entity's Functional Currency

Entity A, whose functional currency is US$, enters into a forward contract that requires Entity A to sell 100 shares of its common stock for 120 euros per share in 1 year. The forward contract is not considered indexed to Entity A's own stock based on the following evaluation:

a. Step 1. The instrument does not contain an exercise contingency. Proceed to Step 2.

b. Step 2. The strike price of the forward contract is denominated in a currency other than the entity's functional currency, so the forward contract is not considered indexed to the entity's own stock.

Example 19: Variability Involving Contingently Convertible Debt with a Market Price Trigger, Parity Provision, and Merger Provision

Entity A issues a contingently convertible debt instrument with a par value of $1,000 that is convertible into 100 shares of its common stock. The convertible debt instrument has a 10-year term and is convertible at any time after any of the following events occurs:

a. Entity A's stock price exceeds $13 per share (market price trigger).

b. The convertible debt instrument trades for an amount that is less than 98 percent of its if-converted value (parity provision).

c. There is an announcement of a merger involving Entity A.

The terms of the convertible debt instrument also include a make-whole provision. Under that provision, if Entity A is acquired for cash before a specified date, the holder of the convertible debt instrument can convert into a number of shares equal to the sum of the fixed conversion ratio (100 shares per bond) and the make-whole shares. The number of make-whole shares is determined by reference to a table with axes of stock price and time. That table was designed such that the aggregate fair value of the shares deliverable (that is, the fair value of 100 shares per bond plus the make-whole shares) would be expected to approximate the fair value of the convertible debt instrument at the settlement date, assuming no change in relevant pricing inputs (other than stock price and time) since the instrument's inception. The embedded conversion option is considered indexed to Entity A's own stock based on the following evaluation:

a. Step 1. The market price trigger and parity provision exercise contingencies are based on observable markets; however, those contingencies relate solely to the market prices of the entity's own stock and its own convertible debt. Also, the merger announcement exercise contingency is not an observable market or an index. Therefore, Step 1 does not preclude the warrants from being considered indexed to the entity's own stock. Proceed to Step 2.

b. Step 2. An acquisition for cash before the specified date is the only circumstance in which the settlement amount will not equal the difference between the fair value of 100 shares and a fixed strike price ($1,000 fixed par value of the debt). The settlement amount if Entity A is acquired for cash before the specified date is equal to the sum of the fixed conversion ratio (100 shares per bond) and the make-whole shares. The number of make-whole shares is determined based on a table with axes of stock price and time, which would both be inputs in a fair value measurement of a fixed-for-fixed option on equity shares.

Example 20: Variability Involving Functional Currency Debt Convertible to a Stock That Trades in a Currency Other Than the Entity's Functional Currency

Entity A, whose functional currency is the Chinese yuan (CNY), issues a debt instrument denominated in CNY with a par value of CNY 1,000 that is convertible into 100 shares of its common stock. Entity A's shares only trade on an exchange in which trades are denominated in US$. Those shares do not trade on an exchange (or other established marketplace) in which trades are denominated in CNY. The convertible debt instrument has a 10-year term and is convertible at any time. The embedded conversion option is considered indexed to Entity A's own stock based on the following evaluation:

a. Step 1. The embedded conversion option does not contain an exercise contingency. Proceed to Step 2.

b. Step 2. Upon exercise of the embedded conversion option, the settlement amount would equal the difference between the fair value of a fixed number of the entity's equity shares (100 shares) and a fixed strike price denominated in its functional currency (CNY 1,000 fixed par value of the debt). The determination of whether the embedded conversion option is indexed to the entity's own stock is not affected by the currency (or currencies) in which the underlying shares trade.

5.2.2.1.4 Ramifications of being indexed to the entity's own stock. If after giving consideration to the two-step test, a conclusion is reached that the freestanding instrument or embedded feature is indexed to the entity's own stock, consideration is given to the section that follows (Section 5.2.2.2) to conclude on the balance sheet classification for that instrument or feature. If the conclusion is reached that an instrument or embedded feature is not indexed to the entity's own stock, it cannot be classified as equity and is accounted for as an asset or a liability (as appropriate), with an initial carrying amount based on fair value. If the instrument or feature meets the definition of a derivative[9] (refer to Section 5.2.2.3), ASC 815-10-35-2 requires ongoing fair value measurement, with changes in fair value reflected in earnings (assuming that the derivative is not designated in a hedge).

Prior to the issuance of ASU 2020-06, there was no specific guidance to address the subsequent measurement of an instrument that is not indexed to the entity's own stock and is not a derivative. ASC 815-40-35-4 requires ongoing fair value measurement with changes in fair value reported in earnings for instruments classified as assets or liabilities under ASC 815-40-25. As is evident from ASC 815-40-15-2 and ASC 815-40-15-5, ASC 815-40 does not apply to nonderivative instruments that are not indexed to the entity's own stock. The SEC staff has a longstanding position that written options that do not qualify for equity classification should be reported at fair value, with changes in fair value recognized through earnings. Ongoing fair value measurement through earnings is generally the preferred approach for other freestanding instruments that are not indexed to the entity's own stock. We are aware that in practice, some reporting entities also referred to the AICPA's Issues Paper, *Accounting for Options* (March 6, 1986), for guidance. Upon the issuance of ASU 2020-06, the FASB amended ASC 815-40-35-4 to require ongoing fair value measurement with changes in fair value reported in earnings for an instrument that is not indexed to the entity's own stock and is not a derivative.

Refer also to Section 5.2.2.4 for the continuous need to reassess the accounting analysis for these instruments.

5.2.2.2 Requirements to be classified in stockholders' equity

This section is relevant to determining the balance sheet classification of instruments or embedded features that were required to be evaluated under Section 5.2.2.1 and determined to be indexed to the entity's own stock.

As discussed within Section 5.2, the settlement methods associated with instruments drive whether or not the instruments will be eligible for equity classification. Balance sheet classification is governed by the guidance in ASC 815-40-25 and is based on the general concept that contracts that include any provision that requires net cash settlement are assets or liabilities and contracts that require settlement in shares are equity instruments. Nuances to this general concept outlined in ASC 815-40-25-1 to 25-9 include the following:

- If the contract provides the company with a choice of net cash settlement or settlement in shares, settlement in shares is assumed (if the settlement alternatives have the same economic value). Conversely, if the contract provides the counterparty (e.g., the investor or holder) with a choice of net cash settlement or settlement in shares, net cash settlement is generally assumed.
- Instruments with settlement alternatives that do not have the same economic value or have a settlement alternative that is fixed or contains caps or floors should be accounted for based on the economic substance of the transaction. This is illustrated through the following example contained at ASC 815-40-25-3: "… if a freestanding contract, issued together with another instrument, requires that the entity provide to the holder a fixed or guaranteed return such that the instruments are, in substance, debt, the entity shall account for both instruments as liabilities, regardless of the settlement terms of the freestanding contract."

[9] Note that ASC 815-40 is not relevant to embedded features that are not derivatives.

- ASC 815-40-25-36 to 25-38 address contracts that have differing settlement alternatives, depending on whether the contract is in a gain or loss position. If the company is required to pay net cash when the contract is in a loss position, the contract should be accounted for as an asset or liability. Conversely, contracts that require the company to receive net cash when the contract is in a gain position, but pay net stock (or net cash at the company's option) when the contract is in a loss position, would be classified as equity if all other criteria are met, as long as the contract is not predominantly a purchased option in which the amount of cash that could be received when the contract is in a gain position is significantly larger than the amount that could be paid when the contract is in a loss position.
- If net cash settlement is triggered only upon the occurrence of a specified event, it is not appropriate to give consideration to the unlikelihood that the event will occur. Consideration should, however, be given to whether the event is within the control of the company. In other words, if the company is in control of whether or not any event occurs that could require net cash settlement, net cash settlement would not be presumed.
- Generally, if an event that is not within the company's control could require net cash settlement, then the contract must be classified as an asset or a liability. However, if the net cash settlement requirement can only be triggered in limited circumstances in which the holders of the shares underlying the contract also would receive cash, equity classification would not be precluded. ASC 815-40-55-2 to 55-6 elaborate on this in the context of a change in control and nationalization event. To illustrate, an event that causes a change in control of a company is not within the company's control, and therefore, if a contract such as a warrant requires net-cash settlement upon a change in control, the warrant must be classified as a liability unless the holders of the class of shares that can be purchased through the warrants are contractually entitled to the same form of consideration (in this case, cash) upon the occurrence of the change in control. If instead of, or in addition to cash, holders of the underlying shares are entitled to different forms of consideration (for example, debt), equity classification would be precluded. As indicated at ASC 815-40-55-2 to 55-5, change-in-control provisions that specify that all stockholders will receive stock of an acquiring company upon a change in control do not affect the classification of the contract.

  On April 12, 2021, the SEC issued a Staff Statement on Accounting and Reporting Considerations for Warrants Issued by Special Purpose Acquisition Companies (“SPACs”), which highlighted a number of important financial reporting considerations for SPACs. Most notably, the statement describes fact patterns that are common in warrants issued in connection with a SPAC’s formation and initial registered offering.

  One of the fact patterns highlighted related to warrants that included a provision that, in the event of a tender or exchange offer made to and accepted by holders of more than 50% of the outstanding shares of a **single class of common stock**, all holders of the warrants would be entitled to receive cash for their warrants. The SEC staff concluded (with reference to the guidance in ASC 815-40-25-7 and 25-8 and related implementation guidance in ASC 815-40-55-2 through 55-6) that, in this fact pattern, equity classification is not appropriate, given that a tender offer is outside the control of the entity and, while all warrant holders would be entitled to cash, only certain of the holders of the underlying shares of common stock would be entitled to cash. This fact pattern specifically addressed the circumstance in which an entity has a dual class structure and the tender offer provision pertained to a non-controlling class of shares. The SEC staff subsequently has clarified that equity classification is precluded in this fact pattern because, as a consequence of this dual class structure, a change in control would not always occur upon this provision being triggered and therefore the limited exception discussed above does not apply. Entities that have a different fact pattern either before or after a SPAC merger may not be precluded from equity classification as a consequence of this provision (e.g., under a single class structure if the tender or exchange offer as described would always result in a change in control and otherwise meets the requirements of ASC 815-40-55-3 through 55-5).

- If cash settlement can only be triggered upon the final liquidation of the entity, equity classification is not precluded.
- Prior to adoption of ASU 2020-06, the equity classification requirements contained within ASC 815-40-25-7 to 25-38 and related interpretive guidance in ASC 815-40-55-2 to 55-6 do not apply to conventional convertible debt. (Refer to Section 3.3.2.2 for additional information.)
- Upon adoption of ASU 2020-06, the equity classification requirements within ASC 815-40-25-7 to 25-30 and ASC 815-40-55-2 to 55-6 do not apply if the hybrid contract is a convertible debt instrument pursuant to which the holder can only realize the value of the conversion option by exercising the option and receiving the entire proceeds in a fixed number of shares or an equivalent amount of cash (at the discretion of the issuer). (Refer to Section 2.3.2.2 of this guide for additional information.)

5.2.2.2.1 Additional equity classification requirements. If the instrument is not convertible debt for which the holder can only realize the value of the conversion option by exercising the option and receiving the entire proceeds in a fixed number of shares or an equivalent amount of cash at the discretion of the issuer (as discussed in Section 2.3.2.2 or Section 3.3.2.2 of this guide, as applicable), the following equity classification requirements in ASC 815-40-25-10 (and further explained in ASC 815-40-25-11 to 25-38) are also relevant:

- Settlement is permitted in unregistered shares.
- The entity has sufficient authorized and unissued shares.
- The contract contains an explicit share limit
- There is no required cash payment if the entity fails to timely file.
- There are no cash settled top-off or make-whole provisions.
- There are no counterparty rights that rank higher than shareholder rights.
- There is no collateral required.

In the event one or more of these requirements is not met, the instrument or feature cannot be classified in equity.

Each of these requirements is discussed in the sections that follow.

Upon the adoption of ASU 2020-06, an entity is not required to consider the following conditions for an instrument or feature to be classified in equity, except as described below.

- Settlement is permitted in unregistered shares. As amended by ASU 2020-06, a requirement to settle in registered shares would not preclude equity classification unless the contract explicitly states that an entity must settle the instrument or feature in cash if registered shares are unavailable.
- There are no counterparty rights that rank higher than shareholder rights. Even if the instrument or feature provides the counterparty with rights that rank higher than those of the holder of the underlying shares, equity classification would not be precluded.
- There is no collateral required. Equity classification would not be precluded if the contract includes a requirement to post collateral.

Interaction with ASU 2020-06

While ASU 2020-06 eliminates these three conditions such that cash settlement is no longer presumed in such circumstances under ASC 815-40-25, corresponding changes have not been made to the SEC guidance in ASC 480-10-S99 on temporary equity classification. Specifically, there is some uncertainty around how the changes to ASC 815-40 impact the application of the SEC guidance in ASC 480-10-S99-3A in determining whether instruments that meet the requirements in ASC 815-40 for equity

treatment should be classified as temporary or permanent equity in light of the scope of this SEC guidance and the requirement in ASC 480-10-S99-3A(6) to consider the guidance in ASC 815-40-25 when determining whether an issuer can control share settlement. Based on informal discussions with the SEC staff, the references in ASC 480-10-S99-3A are to the legacy guidance in ASC 815-40-25 (i.e., guidance in place prior to ASU 2020-06). Entities are encouraged to consult with the SEC in light of this uncertainty and monitor future developments.

5.2.2.2.1.1 Settlement permitted in unregistered shares (ASC 815-40-25-11 to 25-18). As previously mentioned, upon adoption of ASU 2020-06, a requirement to settle in registered shares would not preclude equity classification unless the contract explicitly states that the entity must settle the contract in cash if registered shares are unavailable. The guidance that follows should be considered prior to the adoption of ASU 2020-06, and entities that apply the SEC temporary equity guidance in ASC 480-10-S99 may need to consider it for contracts that meet the requirements of ASC 815-40 to be classified in equity subsequent to the adoption of ASU 2020-06.

The determination of whether or not settlement of a contract is permitted to occur in unregistered shares can be very complex and may warrant consultation with securities counsel. If a contract requires or could require the company to settle it in registered shares, it is assumed that the company will be required to net cash settle the contract. This assumption is based on the premise that an entity cannot control the events or actions necessary to deliver registered shares (e.g., obtaining opinions and consents required for a registration statement) and nonperformance would not be an acceptable outcome. ASC 815-40-25-16 provides an exception as it indicates that if the shares are registered at the inception of the instrument, and there are no further timely filing or registration requirements that would need to be met for the shares to be issued in registered form, share delivery would be within the company's control. Generally, timely filing of annual and quarterly reports is required to maintain the effectiveness of a registration statement.

In addition to considering the contractual requirements to determine if the company could be required to settle in registered shares, consideration should also be given to whether laws governing securities offerings would require settlement in registered shares. This may be the case, for example, if warrants or convertible instruments are issued as part of a registered offering. This issue was elaborated upon in the Remarks by Stephanie L. Hunsaker, Associate Chief Accountant, Division of Corporation Finance, at the AICPA National Conference on Current SEC and PCAOB Developments – 2006. (Keep in mind when referring to these remarks that the relevant guidance in ASC 815-40 was carried over from EITF 00-19.)

ASC 815-40-25-14 indicates that net cash settlement is assumed and equity classification precluded if both of the following conditions are met:

- A derivative instrument requires physical or net share settlement by delivery of registered shares and does not specify any circumstances under which net cash settlement would be permitted or required.
- The derivative instrument does not specify how the contract would be settled in the event that the entity is unable to deliver registered shares.

Said in a different manner, net cash settlement would not be assumed if the contract makes it clear that in the event registered shares cannot be delivered, the company would not be required to net cash settle the contract. Certain contracts provide for an adjustment to the consideration to be given to the counterparty in the event unregistered shares are issued in place of registered shares. ASC 815-40-25-18 indicates that if a settlement alternative includes a penalty that would be avoided by a company under other settlement alternatives, the uneconomic settlement alternative should be disregarded in classifying the contract. (In other words, if the company would incur a penalty to settle the contract in unregistered shares, the company could be economically compelled to net cash settle the contract such that equity classification would not be appropriate.) ASC 815-40-25-18 goes on to indicate that in the case of delivery of unregistered shares, a liquidity discount from the fair value of the corresponding registered shares that is a reasonable estimate of the difference in fair values between registered and unregistered shares is not

considered a penalty. If the contract provides for the fair value of the unregistered shares that will be used in determining the number of shares to be delivered to the counterparty to be determined using commercially reasonable means or by obtaining market quotations, the settlement alternatives would be perceived to have the same economic values.

In the event the contract for the financial instrument or related documents (e.g., shareholder or registration rights agreements) requires the payment of cash penalties in the event the company is unable to register the shares or maintain the effectiveness of a registration statement, consideration should be given to ASC 825-20 to determine if this constitutes a registration payment arrangement that should be given separate recognition as further discussed at Section 1.6. If that is the case, ASC 815-40-25-43 indicates the registration payment obligation would be disregarded when performing the ASC 815-40 analysis of the instrument. We believe that in circumstances whereby a company is only required to use its reasonable best efforts to register the shares that will be issued in satisfaction of the contract (i.e., there are not legal requirements necessitating satisfaction in registered shares), this fact alone would not preclude equity classification as entities can generally control putting forth reasonable best efforts. (This sentiment is reinforced in ASC 815-40-25-28 in the context of obtaining sufficient authorized shares.)

While the focus of this guidance is on registered shares, we believe these concepts could also be applicable when the contract requires delivery of listed shares, and maintaining the listing is not within the control of the company.

5.2.2.2.1.2 Entity has sufficient authorized and unissued shares (ASC 815-40-25-19 to 25-24). The sufficiency of authorized and unissued shares to address all outstanding commitments that the company has to issue shares needs to be considered because the company cannot control share settlement of the contract under evaluation if it is or may become necessary to obtain shareholder approval to increase authorized shares. This evaluation needs to be performed on an ongoing basis and entails comparing the following two amounts:

1. The number of currently authorized but unissued shares, less the maximum number of shares that could be required to be delivered during the contract period under existing commitments, including any of the following:
    - Outstanding convertible debt that is convertible during the contract period
    - Outstanding stock options that are or will become exercisable during the contract period
    - Other derivative financial instruments indexed to, and potentially settled in, an entity's own stock
2. The maximum number of shares that could be required to be delivered under share settlement (either net share or physical) of the contract

Keep in mind the following when performing this comparison:

- The maximum number of shares that could be required to be delivered under a registration payment arrangement should be considered a commitment, regardless of whether the instrument being evaluated is subject to the arrangement.
- If the company has the option to either net-share settle a contract or physically settle by delivering the full number of shares, the alternative that results in the lesser number of maximum shares should be included in this calculation.
- If a contract is classified as an asset or liability because the counterparty has the option to require settlement in cash, for purposes of this calculation, the maximum number of shares that the counterparty could require to be delivered upon physical or net share settlement should be included in this calculation.
- If the contract provides for adjustments to the number of shares that may need to be issued and the events that would trigger the adjustment are within the control of the company, any additional shares

that may need to be issued are not included as a commitment until triggered or not within the company's control.

If the amount in (1) exceeds the amount in (2), and all other conditions are met, share settlement is within the control of the company and the contract should be classified as equity. If there is a shortfall at any point in time, an accounting policy election can be made (so long as it is consistently applied) to allocate available shares to the various commitments to determine what contracts (or portions of contracts for contracts that permit partial net share settlement) that are subject to the equity classification guidance need to be classified (or reclassified) as an asset or liability rather than equity. Refer to Section 5.2.2.4 for additional discussion of this policy election and reclassification.

5.2.2.2.1.3 Contract contains an explicit share limit (ASC 815-40-25-26 to 25-28). For certain contracts, the number of shares that could be required to be delivered upon net-share settlement is essentially indeterminate, in which case the company is not able to conclude that is has sufficient available and unissued shares to settle that contract. Assume, for example, that a perpetual preferred stock instrument with a $1 million carrying amount can be converted into an unlimited variable number of common shares, with the number of shares to be determined based on the issuer's common share price at the date of conversion. If the common share price is $10, the issuer would be required to issue 100,000 shares. If the share price is $.01, the issuer would be required to issue 100 million shares. Since there is no limit on how low the share price can go and therefore no limit on the number of shares the company may need to issue, the company cannot control share settlement for this contract and other share-settled instruments. (No consideration can be given to the improbability that the stock price will decline below a certain amount.) When such an instrument exists, the accounting policy election referred to earlier and discussed in more depth at Section 5.2.2.4 would come into play in determining which of the contracts that are subject to the equity classification requirements of ASC 815-40 cannot be classified as equity given the existence of a contract that requires settlement in an unlimited number of shares. If, for example, the company's policy is that contracts with the latest inception date will be reclassified first (i.e., available shares will be allocated to contracts with the earliest inception date first), this would not pose a problem for contracts issued before the contract that requires settlement in an unlimited number of shares, but would be problematic for subsequently issued contracts that are subject to ASC 815-40. For this reason, it is important to carefully consider potential future ramifications when establishing the accounting policy.

Some contracts contain a cap on the number of shares that will be issued in settlement of the contract and may also require that the issuer deliver the shares in excess of the capped amount when authorized unissued shares become available. The entity is typically required to use its best efforts to authorize sufficient shares to satisfy the obligation. If the contract provides that the number of shares required to settle the excess obligation is fixed on the date that net share settlement of the contract occurs, these additional shares would not need to be considered when determining whether the entity has sufficient, authorized, unissued shares to net share settle the contract. However, if the contract provides that the number of shares that must be delivered to settle the excess obligation will be based on the market value of the shares at the time the excess obligation is settled (to result in a fixed dollar amount of value rather than a fixed number of shares), the excess obligation represents stock-settled debt and equity classification of the contract would be precluded.

5.2.2.2.1.4 No required cash payment if entity fails to timely file (ASC 815-40-25-29). If the contract requires net cash settlement in the event the company does not make timely filings with the SEC, equity classification would be precluded. The ability to make timely filings is not deemed to be within an entity's control. ASU 2020-06 clarified that penalty payments that do not result in the settlement of the instrument do not preclude equity classification.

5.2.2.2.1.5 No cash settled top-off or make-whole provisions (ASC 815-40-25-30). Certain contracts include top-off or make-whole provisions that are generally structured to reimburse the counterparty for any losses it incurs, or to transfer to the company any gains the counterparty recognizes, for the

difference between the settlement date value and the value received by the counterparty in subsequent sales of the securities within a specified time after the settlement date. If this provision must be cash settled or can be cash settled at the counterparty's option, equity classification for the contract would be precluded. If, on the other hand, this provision can be net share settled at the company's option, and the maximum number of shares that could be required to be delivered under the contract is fixed and less than the number of available authorized shares (authorized and unissued shares less the maximum number of shares that could be required to be delivered during the contract period under existing commitments as discussed earlier), a top-off or make-whole provision would not preclude equity classification.

5.2.2.2.1.6 No counterparty rights rank higher than shareholder rights (ASC 815-40-25-31 to 25-34). Prior to the adoption of ASU 2020-06, equity classification would be precluded if a contract gives the counterparty any of the rights of a creditor in the event of the company's bankruptcy. While upon adoption of ASU 2020-06 failure to meet this requirement would no longer preclude equity classification under ASC 815-40-25, as discussed in Section 5.2.2.2.1 of this guide, the guidance that follows may still need to be considered in determining whether temporary equity classification is required under ASC 480-10-S99 for contracts that meet the requirements of ASC 815-40 to be classified in equity.

A counterparty's claim in bankruptcy cannot receive higher priority than the claims of the holders of the underlying stock for the instrument to be classified in equity. The mere fact that the counterparty would have normal contract remedies in the event of a breach of the contract does not preclude equity classification.

ASC 815-40-25-32 acknowledges that depending on the legal jurisdiction and relevant case law, certain rights provided to the counterparty may not be enforceable upon bankruptcy. As a result, even if the contract requires the company to pay cash to settle the contract, the company could not be required to do so in bankruptcy. A contract provision that requires net cash settlement in the event of bankruptcy would not preclude equity classification if it can be demonstrated that, notwithstanding the contract provisions, the counterparty's claims in bankruptcy proceedings could be net share settled or would rank no higher than the claims of the holders of the underlying stock. This is a legal determination that would best be made by legal counsel with bankruptcy expertise**.**

5.2.2.2.1.7 No collateral required (ASC 815-40-25-35). Prior to the adoption of ASU 2020-06, a requirement to post collateral is inconsistent with the concept of equity, and therefore, equity classification is precluded if there is a collateral requirement. While upon adoption of ASU 2020-06 consideration of this item is no longer relevant for equity classification under ASC 815-40-25, as discussed in Section 5.2.2.2.1 of this guide, this condition may still need to be considered in determining whether temporary equity classification is required under ASC 480-10-S99 for contracts that meet the requirements of ASC 815-40 to be classified in equity.

As indicated at ASC 815-40-25-35, collateral in the form of the entity's underlying shares (up to the maximum number of shares that could be delivered under the contract) would not preclude equity classification. While not specifically stated in the guidance, we believe that this condition is focused on collateral requirements of the issuer and that equity classification would not be precluded if the counterparty is subject to collateral requirements.

5.2.2.2.2 Accounting treatment if equity classification requirements are met. If an embedded derivative feature is both indexed to the entity's own stock and meets the requirements to be classified in equity as discussed earlier, it qualifies for the scope exception from derivative treatment under ASC 815-10-15-74(a). In that case, the feature should not be separately recognized as a derivative. (For convertible instruments, refer to Section 2.4, Section 3.4 or Section 4.4 of this guide, as applicable, as conversion features may need to be recognized as a separate component of equity under ASC 470-20.) Freestanding equity-linked instruments that are indexed to the entity's own stock and meet the equity classification requirements discussed earlier are generally classified as additional paid in capital and

either: (a) initially measured at fair value or (b) proportionately allocated proceeds as described at Section 1.3 if issued contemporaneously with other financial instruments. Except as noted in the section that follows, the carrying amount of equity-classified instruments is not subsequently adjusted unless the instrument is modified or requires reclassification. (Refer to the discussion at Section 5.2.2.4 on the need to continuously reassess the accounting treatment for these instruments.) SEC registrants and entities that apply the SEC guidance should give consideration to ASC 480-10-S99 (discussed in Section 4.2.3 of this guide) to determine whether temporary equity presentation and subsequent adjustments to the carrying amount are necessary for an instrument that meets the equity classification requirements.

5.2.2.2.2.1 Subsequent measurement considerations for freestanding equity-classified financial instruments with down round features. Upon the adoption of ASU 2017-11 (refer to Appendix D for additional information), entities that are required to or voluntarily present EPS are required to account for the effect of a down round feature (i.e., the value created through the reduction to the strike price) each time the down round feature is triggered (i.e., the strike price is reduced) in a freestanding equity-classified financial instrument. The effect is accounted for as a dividend through a reduction to retained earnings and an increase to the instrument's carrying amount (e.g., additional paid in capital for warrants). This dividend also reduces income available to common shareholders in the computation of basic EPS. The carrying amount of the equity-classified instrument is not subject to further adjustment unless the down round feature is triggered again.

The amount to be recognized as a dividend is the difference between the following two amounts, determined in accordance with ASC 820 immediately after the down round feature is triggered:

1. The fair value of the financial instrument (ignoring the down round feature) with the strike price that was in effect before the strike price reduction
2. The fair value of the financial instrument (ignoring the down round feature) with the reduced strike price resulting from the down round being triggered

It should be noted that while the down round feature is ignored when determining the fair value of the instrument for the purpose of this computation, all features of an instrument (including a down round feature) should be considered when it is necessary to determine the fair value of an instrument for other purposes (such as to establish its initial carrying amount). An example of this accounting from ASC 260-10-55-95 to 55-97 follows. This accounting does not apply to liability classified instruments, which generally require ongoing fair value measurement. Additionally, as noted previously, entities that do not present EPS do not recognize the effect of triggering a down round feature.

Example 16: Equity-Classified Freestanding Financial Instruments That Include a Down Round Feature

Assume Entity A issues warrants that permit the holder to buy 100 shares of its common stock for $10 per share and that Entity A presents EPS in accordance with the guidance in this Topic. The warrants have a 10-year term, are exercisable at any time, and contain a down round feature. The warrants are classified as equity by Entity A because they are indexed to the entity's own stock and meet the additional conditions necessary for equity classification in accordance with the guidance in Subtopic 815-40 on derivatives and hedging—contracts in entity's own equity (see paragraphs 815-40-55-33 through 55-34A for an illustration of the guidance in Subtopic 815-40 applied to a warrant with a down round feature). Because the warrants are an equity-classified freestanding financial instrument, they are within the scope of the recognition and measurement guidance in this Topic. The terms of the down round feature specify that if Entity A issues additional shares of its common stock for an amount less than $10 per share or issues an equity-classified financial instrument with a strike price below $10 per share, the strike price of the warrants would be reduced to the most recent issuance price or strike price, but the terms of the down round feature are such that the strike price cannot be reduced below $8 per share. After issuing the warrants, Entity A issues shares of its common stock at $7 per share. Because of the subsequent round of financing occurring at a share price below the strike price of the warrants, the down round feature in the warrants is triggered and the strike price of the warrants is reduced to $8 per share.

In accordance with the measurement guidance in paragraphs 260-10-30-1 through 30-2, Entity A determines that the fair value of the warrants (without the down round feature) with a strike price of $10 per share immediately before the down round feature is triggered is $600 and that the fair value of the warrants (without the down round feature) with a strike price of $8 per share immediately after the down round feature is triggered is $750. The increase in the value of $150 is the value of the effect of the triggering of the down round feature.

The $150 increase is the value of the effect of the down round feature to be recognized in equity in accordance with paragraph 260-10-25-1, as follows:

Retained earnings	$150	
Additional paid-in capital		$150

Additionally, Entity A reduces income available to common stockholders in its basic EPS calculation by $150 in accordance with the guidance in paragraph 260-10-45-12B. Entity A applies the treasury stock method in accordance with paragraphs 260-10-45-23 through 45-27 to calculate diluted EPS. Accordingly, the $150 is added back to income available to common stockholders when calculating diluted EPS. However, the treasury stock method would not be applied if the effect were to be antidilutive.

5.2.2.2.3 Accounting treatment if equity classification requirements are not met. Refer to Section 2.3.3 or Section 3.3.3, as applicable, for debt instruments or Section 4.3.5 for preferred or similar stock if an embedded derivative within the instrument such as a conversion option does not meet the equity classification requirements. If the conclusion is reached that an instrument or embedded feature subject to the scope of ASC 815-40 does not meet the equity classification requirements discussed earlier, the instrument or feature is accounted for as an asset or a liability (as appropriate), with an initial and subsequent fair value measurement amount and changes in fair value reflected in earnings (assuming that if the instrument is a derivative, it is not designated in a hedge). The section that follows should be considered to determine if the instrument is a derivative, because if so, the disclosure requirements in ASC 815 are relevant. Refer also to the discussion at Section 5.2.2.4 on the need to continuously reassess the accounting treatment for these instruments.

5.2.2.3 Derivative considerations

This section discusses application of the definition of a derivative to freestanding equity-linked instruments. For a discussion of derivative considerations for features that are embedded in debt, refer to Section 2.3 or Section 3.3, as applicable and refer to Section 4.3, for a discussion of derivative considerations for features that are embedded in preferred and similar stock.

The determination of whether a freestanding instrument is required to be accounted for and disclosed as a derivative entails determining if it has all the characteristics of a derivative and if it qualifies for a scope exception, as summarized at ASC 815-10-15-13. The exception for certain contracts involving an entity's own equity is most commonly relevant to the equity-linked instruments that are the subject of this chapter. As elaborated on at ASC 815-10-15-74, instruments that are both indexed to the entity's own stock in accordance with Section 5.2.2.1 and classified in stockholder's equity in accordance with Section 5.2.2.2 are excluded from the scope of ASC 815, in addition to forward purchase contracts for the entity's shares that require physical settlement. The characteristics of a derivative are outlined and elaborated on at ASC 815-10-15-83 to 15-139 and the related implementation guidance in ASC 815-10-55.

Understanding the terminology

By definition, a derivative instrument has all of the following characteristics:

- One or more underlyings
- One or more notional amounts or payment provisions

- Requires no initial net investment or an initial net investment that is smaller than would be required for other types of contracts that would be expected to have a similar response to changes in market factors
- The contract can be settled net by any of the following means:
  - Its terms implicitly or explicitly require or permit net settlement.
  - It can readily be settled net by a means outside the contract.
  - It provides for delivery of an asset that puts the recipient in a position not substantially different from net settlement.

While an in-depth discussion of derivatives is beyond the scope of this guide, equity-linked instruments typically meet the first three characteristics listed and the derivative conclusion often hinges on whether the contract can be settled net. Consider, for example, a warrant or a forward contract to purchase or sell shares. The fair value of the shares constitutes an underlying. The number of shares that can be purchased through the warrant or must be purchased through the forward contract represent a notional amount. Any initial net investment that may be required to enter into a warrant or forward contract is typically significantly less than the investment that would be required to acquire the shares, in which case, the third characteristic is met.

As it relates to the fourth characteristic, net settlement can occur in various ways. As an example, the contract may provide for the issuer of a warrant to pay cash to the holder equal to the difference between the fair value of the shares at the exercise date and the exercise price of the warrant, or the contract could permit net share settlement such that rather than paying cash to exercise the warrant, the number of shares transferred to the holder upon exercise is reduced to compensate for the exercise price (often referred to as a cashless exercise). If contractual net settlement does not exist, consideration should be given to whether the underlying shares are readily convertible to cash. This typically depends on whether the shares are publicly traded and, if so, the daily transaction volume.

Are the shares readily convertible to cash?

The determination of whether the shares are readily convertible to cash needs to be considered on an ongoing basis throughout a contract's life. Delisting, an IPO or significant changes in the level of trading activity are examples of factors that could influence the conclusion as consideration needs to be given to whether the smallest increment of shares that would be delivered in accordance with each individual contract is small relative to the daily transaction volume. Assume for example that a warrant gives the holder the ability to purchase 100,000 shares of publicly traded common stock. The average daily trading volume associated with the common stock is 50,000 shares. If the warrant is required to be exercised in total, the 100,000 shares are large relative to the daily transaction volume, and the common shares would not be considered to be readily convertible to cash. Most warrants permit exercise in whole or in part (i.e., in whatever increment the holder elects), in which case, generally, the common shares would be considered to be readily convertible to cash if they are actively traded. Refer to ASC 815-10-15-130 to 15-139 for additional information, including special considerations relevant to warrants to purchase shares that have restrictions on their sale or transfer. Additionally, the implementation guidance beginning at ASC 815-10-55-84 may be useful in determining if net settlement exists.

If a conclusion is reached that the equity-linked instrument meets the definition of a derivative, consideration should be given to the scope exceptions outlined at ASC 815-10-15-13. The exception that is most commonly relevant is ASC 815-10-15-74(a). If the instrument is indexed to the entity's stock and classified in stockholders' equity as discussed at Section 5.2.2.1 and Section 5.2.2.2, it would not be accounted for as a derivative. If the instrument does not qualify for this or any other scope exception, it

should be accounted for as an asset or a liability (as appropriate), at fair value, with changes in fair value reflected in earnings (assuming the instrument is not designated in a hedge).

5.2.2.4 Reassessment of contracts for potential reclassification

ASC 815-40-35-8 requires the classification of a contract to be reassessed at each balance sheet date, given that the classification can change for various reasons, including:

- Modifications are made to the terms of the instrument.
- The conclusion changes related to whether an entity can demonstrate it has sufficient authorized shares to share settle a contract.
- If settlement terms for a particular instrument are subject to adjustment for a limited period of time, after the terms are no longer subject to adjustment, an instrument that was not initially indexed to the entity's stock could become indexed.
- Changes in the volume of share activity can impact conclusions reached on whether the shares can be readily converted to cash such that net settlement exists and the instrument is a derivative.

As is elaborated on in ASC 815-40-35, if the required classification of a contract changes as a result of events during the period, the contract should be reclassified as of the date of the event that triggered the reclassification. There is no limit on the number of times a contract may need to be reclassified. If a contract is reclassified from permanent or temporary equity to an asset or a liability, the asset or liability would be measured at its fair value at the reclassification date, with the change in fair value during the period the contract was classified as equity accounted for as an adjustment to stockholders' equity. The asset or liability would be subsequently adjusted to fair value through earnings. If a contract is reclassified from an asset or a liability to equity, gains or losses recorded to account for the contract at fair value during the period that the contract was classified as an asset or a liability are not reversed; however, the carrying amount is not subject to further adjustment as long as the contract continues to qualify for equity classification.

In some cases, it may be necessary to reclassify portions of contracts or multiple contracts. Assume, for example, that an entity does not have sufficient authorized shares to be able to demonstrate that it can control share settlement of a contract in its entirety. (See related discussion in Section 5.2.2.2.1.2.) If the contract in question permits partial net share settlement, the portion that could be net share settled as of the balance sheet date would remain classified in permanent equity, and the remaining portion of the contract would be classified as an asset, a liability or temporary equity, as appropriate. Additionally, when the company cannot demonstrate that it has sufficient authorized shares for all of its outstanding commitments to issue shares, there needs to be an accounting policy in place and consistently applied to determine which contracts, or portions of contracts, that are subject to the scope of ASC 815-40 should be reclassified. ASC 815-40-35-12 acknowledges that different methods may be used to determine the contracts (or portions of contracts) that should be reclassified, and specifically mentions the following as examples of methods that would comply:

- Partial reclassification of all contracts on a proportionate basis
- Reclassification of contracts with the earliest inception date first
- Reclassification of contracts with the earliest maturity date first
- Reclassification of contracts with the latest inception or maturity date first
- Reclassification of contracts with the latest maturity date first

In any case, the method used should be systematic, rational and consistently applied. Refer to the discussion in Section 5.2.2.2.1.3 for an example.

5.2.2.5 Modification or exchange of equity-linked instruments

5.2.2.5.1 Modification or exchange of equity-link instruments classified as equity. Prior to the issuance of ASU 2021-04, there was no guidance to specifically address the accounting for modifications or exchanges of equity-linked instruments such as warrants, which were classified as equity both before and after the modification or exchange. (Refer to Section 5.2.2.4 of this guide for a discussion of the accounting treatment if, as a consequence of the modification, the classification changes). The share-based compensation guidance was often applied by analogy. ASC 718-20-35-3 provides that for equity-classified instruments that remain equity classified subsequent to modification, the excess of the post-modification fair value to the pre-modification fair value, if any, is recognized as an expense in the income statement.

With the issuance of ASU 2021-04, the FASB provided guidance to address the modification or exchange of an equity-classified freestanding written call option, such as a warrant. This guidance relates to instruments that remain equity classified subsequent to the modification or exchange. ASU 2021-04 is effective for all entities for fiscal years beginning after December 15, 2021, including interim periods within those fiscal years, and must be applied prospectively to modifications or exchanges occurring on or after the effective date. Early adoption is permitted.

ASU 2021-04 specifies, that provided another ASC Topic does not apply, such a transaction is treated as an exchange of the original instrument for a new instrument. The effect of the modification or exchange would be measured as follows:

- For a modification or an exchange that is a part of or directly related to a debt modification or exchange, as the difference between the fair value of the modified or exchanged written call option and the fair value of that written call option immediately before it is modified or exchanged.
- For all other modifications or exchanges, as the excess, if any, of the fair value of the modified or exchanged written call option over the fair value of that written call option immediately before it is modified or exchanged.

ASU 2021-04 specifies the effect of the modification or exchange of the call option is recognized on the basis of the substance of the transaction to which it directly relates, in the same manner as if cash had been paid as consideration, as follows:

- For a financing transaction to raise equity (including through modifications to induce the exercise of the call option), the effect should be recognized as an equity-issuance cost in accordance with ASC 340.
- For a debt origination, the effect should be recognized as a debt discount or origination cost in accordance with ASC 835.
- For a debt modification or exchange, the effect should be recognized in accordance with ASC 470-50 and ASC 470-60.
- For modifications or exchanges to compensate for goods or services, the effect should be recognized in accordance with the guidance in ASC 718.
- For all other modifications or exchanges that are not within the scope of another topic within the FASB codification, the effect should be recognized as a dividend with an adjustment to net income or loss in the basic EPS calculation for entities that present EPS.

In a multiple-element transaction (e.g., one that includes both debt financing and equity financing), the total effect of the modification should be allocated to the respective elements in the transaction.

5.2.2.5.1 Modification or exchange of equity-link instruments classified as liabilities. If the instrument that is modified is classified as a liability and carried at fair value, the value attributable to the modification will be captured when the carrying amount of the instrument is subsequently adjusted to fair

value. (Refer to Section 5.2.2.4 for further guidance on the accounting treatment if, as a consequence of the modification, the balance-sheet classification of the instrument changes).

5.2.2.6 Settlement of equity-linked instruments

The settlement of an equity-linked contract generally results in the exchange of cash for shares. As such, upon settlement of an instrument that is classified as equity, cash is debited for the amount received or credited for the amount paid. The appropriate equity accounts are credited for the amount of cash received if shares are issued or debited if shares are purchased.

For those instruments that are required to be accounted for as an asset or liability at fair value through earnings, the instrument's carrying amount should be adjusted to its settlement-date fair value before transferring the carrying amount to equity.

ASC 470-50-40-5 indicates that if debt issued with warrants is permitted to be tendered towards the exercise price of the warrants, any such tendering would be accounted for in the same manner as a conversion of the debt.

5.2.3 Additional consideration for warrants to purchase convertible instruments – Prior to adoption of ASU 2020-06

Upon adoption of ASU 2020-06, the beneficial conversion feature model in ASC 470-20 is eliminated and this Section 5.2.3 is no longer applicable.

Prior to adoption of ASU 2020-06, companies that issue warrants to purchase instruments that are convertible may need to record a beneficial conversion feature associated with the warrant issuance for the inherent intrinsic value of the conversion feature in the convertible instrument to the warrant holder. (This is in addition to potential beneficial conversion features that may need to be recognized related to the convertible instrument itself as required by ASC 470-20 and discussed in Section 3.4 for convertible debt and Section 4.4 for convertible stock.) Freestanding warrants are not included in the scope of ASC 470-20; however, the EITF formed tentative conclusions on how this guidance should be applied to warrants that was published in EITF 00-27, but never finalized. While this guidance is not included in the ASC, we believe it is generally applied in practice. The tentative conclusions reached by the EITF in the context of a warrant that allows the holder to acquire a convertible instrument for a stated exercise price and requires physical settlement are summarized and illustrated through examples in the table that follows and differ depending on the balance sheet classification of the warrant (as equity or liability).

	Equity warrant (Issues 13(a) to (c) in EITF 00-27)	Liability warrant (Issue 14 in EITF 00-27)
Date used to measure the intrinsic value	Commitment date if the issuer receives fair value consideration for the warrant at its issuance (or for the warrant and any other instruments issued at the same time); if not, exercise date	Exercise date
Computation of deemed proceeds for the convertible instrument	Sum of the proceeds received for (or allocated to) the warrant and the exercise price of the warrant	Sum of the carrying amount of the warrant at the exercise date and the warrant's exercise price
Timing of recognition	Amount up to the total proceeds originally received for (or allocated to) the warrant is accounted for as a deemed distribution to the holder of the warrant and recognized over the life of the warrant. On the date the	Upon exercise

	Equity warrant (Issues 13(a) to (c) in EITF 00-27)	Liability warrant (Issue 14 in EITF 00-27)
	warrant is exercised, any excess intrinsic value and any remaining unamortized intrinsic value measured at the date the warrant was issued should be combined and amortized in accordance with ASC 470-20-35-7.	

The following examples published in EITF 00-27 illustrate the application of this guidance.

Example: Warrant classified as equity (from paragraphs 46 to 48 of Part II of EITF 00-27)

Assume Company A issues a freestanding warrant to Company B on January 15, 20X0, for its fair value, $20. Also assume the commitment date for the warrant is the date of issuance. The warrant provides Company B with the right during the next 2 years to exercise the warrant for $100 in cash and receive 1 share of Company A $100 par value nonredeemable convertible preferred stock. The preferred stock is convertible into 10 shares of Company A common stock 1 year after the preferred stock's issuance date. Also assume that the terms of the warrant require physical settlement upon exercise and Company A has determined that the warrant is classified in equity. The fair value of Company A common stock on January 15, 20X0, is $15 per share. Company B exercises the warrant on July 15, 20X0, when the fair value of Company A stock is $20 per share.

The sum of the proceeds received for the warrant ($20) and the warrant's exercise price ($100) equals $120, which is considered to be the proceeds of issuance of the convertible instrument pursuant to the Task Force's tentative conclusion on Issue 13(b). The fair value (as of the commitment date of the warrant pursuant to the Task Force's tentative conclusion on Issue 13(a)) of Company A's common stock that would be received upon exercising the conversion option in the convertible instrument is equal to $150 ($15 per share × 10 shares). The difference between the fair value of the common stock ($150) and the proceeds of issuance of the convertible instrument ($120) is $30, which represents the intrinsic value of the conversion option in the instrument underlying the warrant (that is, a beneficial conversion option exists).

The amount of the beneficial conversion option recognized upon issuance of the warrant would be limited to $20, the amount of proceeds received for the warrant (pursuant to the Task Force's tentative conclusion on Issue 13(c)). That amount would be recognized over the life of the warrant as a distribution to the warrant holder. Through the date the warrant is exercised, Company A recognized approximately $5 in amortization of the $20 beneficial conversion amount as a distribution to the warrant holder (that is, the remaining unamortized balance is $15). When the warrant is exercised and the convertible preferred stock is issued, the amount of the originally measured intrinsic value of the conversion option ($30) in excess of the proceeds received for the warrant ($20) of $10 is recognized. The sum ($25) of that $10 increment and the $15 unamortized amount of the $20 intrinsic value measured at the date the warrant was issued is immediately recognized as a deemed distribution to the holder of the convertible preferred stock because the instrument is not redeemable and is immediately convertible by the holder.

Example: Warrant classified as liability (from paragraphs 50 and 51 of Part II of EITF 00-27)

Assume that Company A issues a freestanding warrant to Company B on January 15, 20X0, for its fair value, $20. Also assume the commitment date for the warrant is the date of issuance. The warrant provides Company B with the right during the next 2 years to exercise the warrant for $100 in cash and receive Company A $100 par value convertible debt. The debt is convertible into 10 shares of Company A common stock. The fair value of Company A stock on January 15, 20X0, is $11 per share. Company B exercises the warrant on February 15, 20X1, when the fair value of Company A stock is $20 per share and the fair value and carrying amount of the warrant is $105. Also assume that the warrant terms require physical settlement upon exercise and Company A has determined that the warrant is classified as a liability.

Because Company A has classified the warrant as a liability instrument, the exercise date for the warrant should be used to measure and recognize the intrinsic value of the conversion option in the convertible instrument that is the underlying for the warrant. Accordingly, the fair value of the stock on the exercise date of $20 per share should be used to calculate the intrinsic value of the conversion option. When the warrant is classified as a liability instrument, the deemed proceeds for the convertible instrument ($205) should equal the sum of the carrying amount of the warrant at the exercise date ($105) and the warrant's exercise price ($100). In this example, there is no beneficial conversion option because the amount of proceeds ($205) exceeds the fair value of the common stock into which the instrument can be converted ($200, calculated as $20 per share × 10 shares). The exercise of the warrant and resulting issuance of the convertible debt would be recorded as follows:

Cash	$100	
Warrant Liability	105	
Convertible Debt		$100
Additional Paid-in Capital		105[5]

[5] The Task Force observed that in this example the accounting resulted in recording the convertible debt at a substantial premium. In this situation, paragraph 18 of Opinion 14 indicates that there is a presumption that the premium represents additional paid-in capital.

5.3 Accelerated share repurchase program

Entities sometimes conduct accelerated share repurchase programs as a way of making an immediate purchase of a large number of shares, with the final purchase price of the shares based on an average market price over a fixed period of time. Such programs are used to obtain immediate share retirement benefits without disrupting the market. ASC 505-30 governs the accounting treatment for these arrangements and specifies that the arrangement should be accounted for as two separate transactions; namely, a treasury stock purchase on the acquisition date and a forward contract indexed to the entity's common stock.

The following examples are included in ASC 505-30-55-3 and ASC 505-30-55-5.

Example: Treasury stock purchase

Investment Banker, an unrelated third party, borrows 1,000,000 shares of Company A common stock from investors, becomes the owner of record of those shares, and sells the shares short to Company A on July 1, 1999, at the fair value of $50 per share. Company A pays $50,000,000 in cash to Investment Banker on July 1, 1999, to settle the purchase transaction. The shares are held in treasury. Company A has legal title to the shares, and no other party has the right to vote those shares.

Example: Forward contract

Company A simultaneously enters into a forward contract with Investment Banker on 1,000,000 shares of its own common stock. On the October 1, 1999, settlement date, if the volume-weighted average daily market price of Company A's common stock during the contract period (July 1, 1999, to October 1, 1999) exceeds the $50 initial purchase price (net of a commission fee to Investment Banker), Company A will deliver to Investment Banker cash or shares of common stock (at Company A's option) equal to the price difference multiplied by 1,000,000. If the volume-weighted average daily market price of Company A's common stock during the contract period is less than the $50 initial purchase price (net of a commission fee to Investment Banker), Investment Banker will deliver to Company A cash equal to the price difference multiplied by 1,000,000.

There are many variations of accelerated share repurchase programs, and the nuances of each can impact the accounting treatment. The approach outlined at Section 5.2 would be followed in determining the accounting treatment for the forward contract.

Appendix A: Acronyms and literature references

Several acronyms are used throughout this guide and numerous references are made to specific topics and subtopics in the ASC. Provided in this appendix are: (a) an acronym legend, which lists the acronyms used throughout this guide and their corresponding definitions, and (b) a literature listing, which lists the topics and subtopics referred to throughout this guide and the corresponding titles.

A.1 Acronym legend

Acronym	Definition
AICPA	American Institute of Certified Public Accountants
APIC	Additional paid-in capital
ASC	FASB's Accounting Standards Codification
ASU	Accounting Standards Update
EITF	FASB Emerging Issues Task Force
EPS	Earnings per share
FAS	FASB Statements
FASB	Financial Accounting Standards Board
FSP	FASB Staff Positions
GAAP	Generally accepted accounting principles
IPO	Initial public offering
SEC	U.S. Securities and Exchange Commission
SPAC	Special-purpose acquisition company

A.2 Literature listing

ASC topic or subtopic	Title
260-10	Earnings Per Share – Overall
340	Other Assets and Deferred Costs
450	Contingencies
450-20	Contingencies – Loss Contingencies
470-10	Debt – Overall
470-20	Debt – Debt with Conversion and Other Options
470-50	Debt – Modifications and Extinguishments
470-60	Debt – Troubled Debt Restructurings by Debtors
480	Distinguishing Liabilities from Equity
480-10	Distinguishing Liabilities from Equity - Overall
505-10	Equity – Overall
505-30	Equity – Treasury Stock
505-50	Equity – Equity-Based Payments to Non-Employees
718	Compensation—Stock Compensation
718-20	Compensation—Stock Compensation – Awards Classified as Equity

ASC topic or subtopic	Title
740-10	Income Taxes – Overall
815	Derivatives and Hedging
815-10	Derivatives and Hedging – Overall
815-15	Derivatives and Hedging – Embedded Derivatives
815-40	Derivatives and Hedging – Contracts in Entity's Own Equity
820	Fair Value Measurement
825	Financial Instruments
825-20	Financial Instruments – Registration Payment Arrangements
835	Interest
835-30	Interest – Imputation of Interest

Other literature	Title
ASU 2014-16	Derivatives and Hedging (Topic 815): Determining Whether the Host Contract in a Hybrid Financial Instrument Issued in the Form of a Share Is More Akin to Debt or to Equity
ASU 2017-11	Earnings Per Share (Topic 260), Distinguishing Liabilities from Equity (Topic 480), Derivatives and Hedging (Topic 815): I. Accounting for Certain Financial Instruments with Down Round Features, II. Replacement of the Indefinite Deferral for Mandatorily Redeemable Financial Instruments of Certain Nonpublic Entities and Certain Mandatorily Redeemable Noncontrolling Interests with a Scope Exception
ASU 2018-07	Compensation—Stock Compensation (Topic 718): Improvements to Nonemployee Share-Based Payment Accounting
ASU 2020-06	Debt—Debt with Conversion and Other Options (Subtopic 470-20) and Derivatives and Hedging—Contracts in Entity's Own Equity (Subtopic 815-40): Accounting for Convertible Instruments and Contracts in an Entity's Own Equity
ASU 2021-04	Earnings Per Share (Topic 260), Debt—Modifications and Extinguishments (Subtopic 470-50), Compensation—Stock Compensation (Topic 718), and Derivatives and Hedging—Contracts in Entity's Own Equity (Subtopic 815-40): Issuer's Accounting for Certain Modifications or Exchanges of Freestanding Equity-Classified Written Call Options (a consensus of the FASB Emerging Issues Task Force)
EITF 00-19	Accounting for Derivative Financial Instruments Indexed to, and Potentially Settled in, a Company's Own Stock
EITF 00-27	Application of Issue No. 98-5 to Certain Convertible Instruments
AICPA Technical Questions and Answers Section 4210.01	Dividends – Write-Off of Liquidating Dividends
AICPA Technical Questions and	Dividends – Accrual of Preferred Dividends

Other literature	Title
Answers Section 4210.04	
FAS 150	Accounting for Certain Financial Instruments with Characteristics of both Liabilities and Equity
FSP FAS 150-5	Issuer's Accounting under FASB Statement No. 150 for Freestanding Warrants and Other Similar Instruments on Shares That Are Redeemable

Appendix B: Definitions

Several terms with specific meaning are used throughout this guide. Those terms and the corresponding definition are provided in the table that follows. To the extent the term is defined in the Master Glossary of the ASC, that definition is provided.

Term	Definition
Beneficial conversion feature	A nondetachable conversion feature that is in the money at the commitment date.
Commitment date	The date when an agreement has been reached that meets the definition of a firm commitment.
Contingently convertible instruments	Instruments that have embedded conversion features that are contingently convertible or exercisable based on either of the following: a. A market price trigger b. Multiple contingencies if one of the contingencies is a market price trigger and the instrument can be converted or share settled based on meeting the specified market condition. A market price trigger is a market condition that is based at least in part on the issuer's own share price. Examples of contingently convertible instruments include contingently convertible debt, contingently convertible preferred stock, and the instrument described by paragraph 260-10-45-43, all with embedded market price triggers.
Conversion shares	The shares into which a convertible instrument can be converted. In other words, if preferred stock or debt is convertible into common stock, the conversion shares are the common stock that would be received in satisfaction of the convertible instrument upon conversion.
Convertible debt	A convertible debt instrument generally provides an option to the holder to convert the instrument into a predetermined number of common or preferred shares rather than receive repayment of the face amount in cash or cash equivalents.
Convertible security	A security that is convertible into another security based on a conversion rate. For example, convertible preferred stock that is convertible into common stock on a two-for-one basis (two shares of common for each share of preferred).
Derivative instrument	A financial instrument or other contract with all of the following characteristics: a. The contract has both of the following terms, which determine the amount of the settlement or settlements, and, in some cases, whether or not a settlement is required: 1. One or more underlyings 2. One or more notional amounts or payment provisions or both.

Term	Definition
	b. The contract requires no initial net investment or an initial net investment that is smaller than would be required for other types of contracts that would be expected to have a similar response to changes in market factors. c. The contract can be settled net by any of the following means: 1. Its terms implicitly or explicitly require or permit net settlement. 2. It can readily be settled net by a means outside the contract. 3. It provides for delivery of an asset that puts the recipient in a position not substantially different from net settlement.
Down round feature	A feature in a financial instrument that reduces the strike price of an issued financial instrument if the issuer sells shares of its stock for an amount less than the currently stated strike price of the issued financial instrument or issues an equity-linked financial instrument with a strike price below the currently stated strike price of the issued financial instrument. A down round feature may reduce the strike price of a financial instrument to the current issuance price, or the reduction may be limited by a floor or on the basis of a formula that results in a price that is at a discount to the original exercise price but above the new issuance price of the shares, or may reduce the strike price to below the current issuance price. A standard antidilution provision is not considered a down round feature.
Embedded derivative	Implicit or explicit terms that affect some or all of the cash flows or the value of other exchanges required by a contract in a manner similar to a derivative instrument.
Equity restructuring	A nonreciprocal transaction between an entity and its shareholders that causes the per-share fair value of the shares underlying an option or similar award to change, such as a stock dividend, stock split, spinoff, rights offering, or recapitalization through a large, nonrecurring cash dividend.
Exercise contingency	A provision that entitles the entity (or the counterparty) to exercise an equity-linked financial instrument (or embedded feature) based on changes in an underlying, including the occurrence (or nonoccurrence) of a specified event. Provisions that accelerate the timing of the entity's (or the counterparty's) ability to exercise an instrument and provisions that extend the length of time that an instrument is exercisable are examples of exercise contingencies.
Financial instrument	Cash, evidence of an ownership interest in an entity, or a contract that both: a. Imposes on one entity a contractual obligation either: 1. To deliver cash or another financial instrument to a second entity 2. To exchange other financial instruments on potentially unfavorable terms with the second entity. b. Conveys to that second entity a contractual right either: 1. To receive cash or another financial instrument from the first entity

Term	Definition
	2. To exchange other financial instruments on potentially favorable terms with the first entity.
Firm commitment	An agreement with an unrelated party, binding on both parties and usually legally enforceable, with the following characteristics: a. The agreement specifies all significant terms, including the quantity to be exchanged, the fixed price, and the timing of the transaction. The fixed price may be expressed as a specified amount of an entity's functional currency or of a foreign currency. It may also be expressed as a specified interest rate or specified effective yield. The binding provisions of an agreement are regarded to include those legal rights and obligations codified in the laws to which such an agreement is subject. A price that varies with the market price of the item that is the subject of the firm commitment cannot qualify as a fixed price. For example, a price that is specified in terms of ounces of gold would not be a fixed price if the market price of the item to be purchased or sold under the firm commitment varied with the price of gold. b. The agreement includes a disincentive for nonperformance that is sufficiently large to make performance probable. In the legal jurisdiction that governs the agreement, the existence of statutory rights to pursue remedies for default equivalent to the damages suffered by the nondefaulting party, in and of itself, represents a sufficiently large disincentive for nonperformance to make performance probable for purposes of applying the definition of a firm commitment.
Freestanding financial instrument	A financial instrument that meets either of the following conditions: a. It is entered into separately and apart from any of the entity's other financial instruments or equity transactions. b. It is entered into in conjunction with some other transaction and is legally detachable and separately exercisable.
Host contract	A hybrid instrument exclusive of the embedded derivative.
Hybrid instrument	A contract that embodies both an embedded derivative and a host contract.
Interest method	The method used to arrive at a periodic interest cost (including amortization) that will represent a level effective rate on the sum of the face amount of the debt and (plus or minus) the unamortized premium or discount and expense at the beginning of each period.
Make-whole provision	A cash payment to a counterparty if the shares initially delivered upon settlement are subsequently sold by the counterparty and the sales proceeds are insufficient to provide the counterparty with full return of the amount due. While the exact terms of such provisions vary, they generally are intended to reimburse the counterparty for any losses it incurs or to transfer to the entity any gains the counterparty recognizes on the difference between the following: a. The settlement date value

Term	Definition
	b. The value received by the counterparty in subsequent sales of the securities within a specified time after the settlement date.
Monetary value	What the fair value of the cash, shares, or other instruments that a financial instrument obligates the issuer to convey to the holder would be at the settlement date under specified market conditions.
Net cash settlement	The party with a loss delivers to the party with a gain a cash payment equal to the gain, and no shares are exchanged.
Net share settlement	The party with a loss delivers to the party with a gain shares with a current fair value equal to the gain.
Notional amount	A number of currency units, shares, bushels, pounds, or other units specified in a derivative instrument. Sometimes other names are used. For example, the notional amount is called a face amount in some contracts.
Obligation	A conditional or unconditional duty or responsibility to transfer assets or to issue equity shares. Because Topic 480 relates only to financial instruments and not to contracts to provide services and other types of contracts, but includes duties or responsibilities to issue equity shares, this definition of obligation differs from the definition found in FASB Concepts Statement No. 6, Elements of Financial Statements, and is applicable only for items in the scope of that Topic.
Payment provision	A payment provision specifies a fixed or determinable settlement to be made if the underlying behaves in a specified manner.
Physical settlement	The party designated in the contract as the buyer delivers the full stated amount of cash to the seller, and the seller delivers the full stated number of shares to the buyer.
Public business entity	A business entity meeting any one of the criteria below. Neither a not-for-profit entity nor an employee benefit plan is a business entity. a. It is required by the U.S. Securities and Exchange Commission (SEC) to file or furnish financial statements, or does file or furnish financial statements (including voluntary filers), with the SEC (including other entities whose financial statements or financial information are required to be or are included in a filing). b. It is required by the Securities Exchange Act of 1934 (the Act), as amended, or rules or regulations promulgated under the Act, to file or furnish financial statements with a regulatory agency other than the SEC. c. It is required to file or furnish financial statements with a foreign or domestic regulatory agency in preparation for the sale of or for purposes of issuing securities that are not subject to contractual restrictions on transfer. d. It has issued, or is a conduit bond obligor for, securities that are traded, listed, or quoted on an exchange or an over-the-counter market.

Term	Definition
	e. It has one or more securities that are not subject to contractual restrictions on transfer, and it is required by law, contract, or regulation to prepare U.S. GAAP financial statements (including notes) and make them publicly available on a periodic basis (for example, interim or annual periods). An entity must meet both of these conditions to meet this criterion. An entity may meet the definition of a public business entity solely because its financial statements or financial information is included in another entity's filing with the SEC. In that case, the entity is only a public business entity for purposes of financial statements that are filed or furnished with the SEC.
Readily convertible to cash	Assets that are readily convertible to cash have both of the following: a. Interchangeable (fungible) units b. Quoted prices available in an active market that can rapidly absorb the quantity held by the entity without significantly affecting the price.
Securities and Exchange Commission (SEC) filer	An entity that is required to file or furnish its financial statements with either of the following: a. The Securities and Exchange Commission (SEC) b. With respect to an entity subject to Section 12(i) of the Securities Exchange Act of 1934, as amended, the appropriate agency under that Section. Financial statements for other entities that are not otherwise SEC filers whose financial statements are included in a submission by another SEC filer are not included within this definition.
Standard antidilution provisions	Provisions that result in adjustments to the conversion ratio in the event of an equity restructuring transaction that are designed to maintain the value of the conversion option.
Underlying	A specified interest rate, security price, commodity price, foreign exchange rate, index of prices or rates, or other variable (including the occurrence or nonoccurrence of a specified event such as a scheduled payment under a contract). An underlying may be a price or rate of an asset or liability but is not the asset or liability itself. An underlying is a variable that, along with either a notional amount or a payment provision, determines the settlement of a derivative instrument.
Written put option	An option that obligates the option seller to buy shares from the option holder.

Appendix C: High Level Overview of ASU 2020-06

The FASB issued ASU 2020-06, *Debt—Debt with Conversion and Other Options (Subtopic 470-20) and Derivatives and Hedging—Contracts in Entity's Own Equity (Subtopic 815-40): Accounting for Convertible Instruments and Contracts in an Entity's Own Equity*, to address the complexity in accounting for certain financial instruments with characteristics of liabilities and equity. Among other provisions, the amendments in this ASU significantly change the guidance regarding the issuer's accounting for convertible instruments and the guidance on the derivative scope exception for contracts in an entity's own equity such that fewer conversion features will require separate recognition, and fewer freestanding instruments, like warrants, will require liability treatment.

C.1 Convertible instruments

C.1.1 Simplified accounting models

As discussed in Chapter 3 of this guide, the guidance in place prior to the adoption of ASU 2020-06 on the accounting for convertible debt from the issuer's perspective includes five accounting models: (1) the embedded derivative model, (2) the cash conversion model, (3) the beneficial conversion feature model, (4) the substantial premium model and (5) the traditional convertible debt model.

As discussed in Chapter 4, under the guidance in place prior to the adoption of ASU 2020-06. convertible preferred stock is subject to evaluation under the embedded derivative model, the cash conversion model if it is mandatorily redeemable preferred stock that is accounted for as a liability under ASC 480 and the beneficial conversion feature model. If none of these models require separate recognition of the conversion feature, convertible preferred stock is accounted for as a single instrument in its entirety under the traditional convertible preferred stock model.

With the issuance of ASU 2020-06, certain separation models in ASC 470-20 are eliminated. This includes the cash conversion model and the beneficial conversion feature model. Unless the conversion features are required to be accounted for separately as derivatives under ASC 815, or a convertible debt instrument is issued at a substantial premium that is required to be accounted for as paid-in-capital, the embedded conversion feature will not be separated from the host instrument.

Spotlight on change

By eliminating certain ASC 470-20 separation models, the interest rate of convertible debt instruments will be closer to the coupon interest rate when applying the guidance in ASC 835 rather than a higher interest rate that results from the separation of conversion features. (For example, when a conversion feature is recognized separate from the debt, the allocation of proceeds to the conversion feature creates a discount on the debt, which must be amortized to interest expense over the life of the convertible debt instrument.) Financial statement users indicated to the FASB that cash (coupon) interest expense is most relevant for their analyses.

By eliminating these models, the amendments also remove some of the complexity in the accounting for convertible instruments. For example, the beneficial conversion model could require consideration and measurement of the beneficial conversion feature at the time of issuance, as contingencies lapse, when adjustments or resets are made and upon conversion or extinguishment of the convertible instrument. For private companies in particular, this model also could necessitate the cost and burden of multiple stock valuations.

C.1.2 Disclosures

The ASU also includes additional disclosure requirements related to convertible instruments intended to increase transparency. Amendments to the disclosures include:

- Adding a disclosure objective. The objective of the disclosures is to provide users of the financial statements with information on the terms and features of convertible debt instruments, an understanding of how those instruments have been reported in an entity's statement of financial position and statement of financial performance, and information about events, conditions and circumstances that can affect the assessment about the amount or timing of an entity's future cash flows related to those instruments.
- Adding a requirement to disclose information about events or conditions that occur during the reporting period that cause conversion contingencies to be met or conversion terms to be significantly changed.
- Adding a detailed list of rights and privileges that should be disclosed, including which party controls the conversion rights.
- Aligning disclosure requirements for contingently convertible instruments with other convertible instruments.
- Requiring existing fair value disclosures required for public business entities in ASC 825 to be provided at the individual convertible debt instrument level.

ASC 470-20-55-69A to 55-69F provide illustrations of the new disclosure requirements.

C.2 Derivatives scope exception for contracts in an entity's own equity

An equity-linked instrument or feature may qualify for a scope exception from derivative accounting under ASC 815-40. As discussed in Chapter 5 of this guide, to meet this scope exception, an equity-linked instrument or feature must (a) be indexed to an entity's own stock and (b) be classified in equity.

The determination as to whether an equity-linked instrument or feature meets the requirements to be classified in equity involves evaluating the settlement methods. The general concept is that contracts that include any provision that requires net cash settlement are assets or liabilities, and contracts that require settlement in shares are equity instruments. Because any contract provision that could require net cash settlement precludes accounting for a contract as equity (except for those circumstances in which the holders of the underlying shares would receive cash) the guidance in ASC 815-40 that is in effect prior to the adoption of ASU 2020-06 includes seven additional conditions that must be met for a contract within its scope to be classified as equity:

- Settlement is permitted in unregistered shares.
- The entity has sufficient authorized and unissued shares.
- The contract contains an explicit share limit.
- There is no required cash payment if the entity fails to timely file with the SEC.
- There are no cash settled top-off or make-whole provisions.
- There are no counterparty rights that rank higher than shareholder rights.
- There is no collateral required.

ASU 2020-06 revised the guidance in ASC 815-40 to:

- Remove the following conditions:
  - Settlement is permitted in unregistered shares. (However, the ASU specifies that when the contract explicitly states that an entity must settle in cash if registered shares are unavailable, equity classification would still be precluded.)
  - There are no counterparty rights that rank higher than shareholder rights.
  - There is no collateral required.

- Clarify the condition for no required cash payments if an entity fails to timely file to state that penalty payments that don't result in the settlement of the instruments do not preclude equity classification.

Spotlight on change

The removal of these conditions may significantly reduce the amount of time and effort needed for some entities to complete the analysis to determine whether a freestanding instrument (such as a warrant) or embedded feature (such as a conversion option) qualifies for a scope exception from derivative accounting. For example, the requirement to determine whether settlement was permitted in unregistered shares can be an onerous one. Extensive time and effort often is needed to analyze agreements associated with registered offerings to determine whether the entity could be forced to cash settle an instrument as a result of securities laws or the contract requiring settlement in registered shares. By reducing the requirements to qualify for the derivative scope exception in ASC 815-40, the revisions in ASU 2020-06 will not only reduce the amount of time and effort required to perform the accounting analysis that is required for instruments within its scope, but also reduce the number of instruments that are required to be accounted for as derivatives.

There is some uncertainty around how the changes to ASC 815-40 will impact the application of the SEC guidance in ASC 480-10-S99-3A in determining whether instruments that meet the requirements in ASC 815-40 for equity treatment should be classified as temporary or permanent equity in light of the scope of this SEC guidance and the requirement in ASC 480-10-S99-3A(6) to consider the guidance in ASC 815-40-25 when determining whether an issuer can control share settlement. Entities are encouraged to consult with the SEC in light of this uncertainty and monitor future developments.

Other changes made by ASU 2020-06 include:

- Specifically indicating that instruments that do not meet the criteria to be considered indexed to an entity's own stock should be measured subsequently at fair value through earnings.
- Clarifying that the disclosure requirements in ASC 815-40-50 apply only to freestanding instruments, not embedded features.
- Clarifying that the scope of the reassessment guidance in ASC 815-40-35 on subsequent measurement applies to both freestanding instruments and embedded features.

Spotlight on change

If the conclusion is reached that an instrument or embedded feature is not indexed to the entity's own stock, it cannot be classified as equity and is accounted for as an asset or liability (as appropriate), with an initial carrying amount based on fair value. If the instrument or feature meets the definition of a derivative, ASC 815-10-35-2 requires ongoing fair value measurement. However, prior to the issuance of ASU 2020-06, there was no specific guidance to address the subsequent measurement of an instrument that is not indexed to the entity's own stock and is not a derivative. The new provision under the ASU requiring such instruments to be subsequently measured at fair value will eliminate any confusion or diversity that may have resulted from this gap in guidance. Entities that have encountered this situation and carried such instruments at other than fair value should be alert to the change this provision will have to their financial statements upon adoption of the ASU.

C.3 Earnings per share (EPS)

ASU 2020-06 also provides for improvements to EPS guidance related to (a) convertible instruments and (b) instruments that qualify for the derivatives scope exception for contracts in an entity's own equity in ASC 815-40. The amendments improve the consistency of EPS calculations by amending the guidance as follows:

- Requiring that an entity use the if-converted method for convertible instruments in the calculation of diluted EPS.
- Requiring the effect of potential share settlement be included in the calculation of diluted EPS when an instrument may be settled in cash or shares. Existing guidance, which allowed entities to overcome the presumption of share settlement, is eliminated.
- Including equity-classified convertible preferred stock that includes a down round feature within the scope of the recognition and measurement guidance for financial instruments that include down round features in ASC 260.
- Clarifying that an average market price should be used to calculate the denominator for diluted EPS if the exercise prices may change based on an entity's share price or if changes in the entity's share price may affect the number of shares that may be used to settle a financial instrument.
- Clarifying that the weighted-average share count from each quarter should be used when calculating the year-to-date weighted-average share count.

Spotlight on change

Prior to the adoption of ASU 2020-06, under ASC 260 entities that present EPS must recognize the effect of the down round feature for an equity-classified freestanding warrant or option when it is triggered. That effect is recognized as a dividend and as a reduction of income available to common shareholders in basic EPS. With the issuance of the ASU, the scope of the guidance on accounting for financial instruments that include down round features in ASC 260 was amended to add equity-classified convertible preferred stock instruments that include down round features. These instruments were previously excluded because of the application of the beneficial conversion feature model. However, with the elimination of the beneficial conversion feature model, the FASB decided that the down round recognition guidance in ASC 260 should apply to those instruments and that the triggering of a down round feature included in equity-classified convertible preferred stock should have the same accounting treatment as the triggering of a down round feature included in an equity-classified freestanding warrant or option.

However, the FASB decided not to extend this guidance to convertible debt instruments. ASC 825 already requires public business entities to disclose fair value information for convertible debt instruments, which, in the FASB's view, provides financial statement users with sufficient information for these instruments because changes in the down round feature (such as a trigger) should be captured within the fair value measurement.

C.4 Effective date and transition

ASU 2020-06 is effective for public business entities that meet the definition of an SEC filer, excluding entities eligible to be smaller reporting companies as defined by the SEC and based on their most recent determination as of August 5, 2020, for fiscal years beginning after December 15, 2021, including interim periods within those fiscal years. For all other entities, the ASU is effective for fiscal years beginning after December 15, 2023, including interim periods within those fiscal years. Early adoption is permitted, but no earlier than fiscal years beginning after December 15, 2020, including interim periods within those fiscal years.

Entities are allowed to adopt the ASU through either a modified retrospective method of transition or a fully retrospective method of transition. Under the modified retrospective method, entities should apply the guidance to transactions outstanding as of the beginning of the fiscal year in which the amendments are adopted. Transactions that were settled (or expired) during prior reporting periods are unaffected. An entity should adjust the carrying amount of an affected instrument (or feature) to what it would have been if the entity had applied the amendments from the inception of the instrument (or feature). The entity

should record the offset of the carrying amount adjustment in retained earnings at the date of adoption. Under this method, prior-period earnings-per-share amounts are not restated.

Under the fully retrospective method of transition, an entity must apply the guidance retrospectively to all instruments outstanding as of the beginning of the first comparative period. The cumulative effect of the change in guidance should be reflected in the carrying amounts of assets and liabilities as of the beginning of the first period presented with an offsetting adjustment to the opening balance of retained earnings.

Spotlight on change

To determine the impact of adoption, an entity would need to reperform the accounting analysis for outstanding instruments as though ASU 2020-06 was in effect throughout the life of each instrument. The adoption of the convertible instrument provisions of ASU 2020-06 may result in an entity recombining convertible instruments for which a portion of the instrument was previously separated and recorded in the APIC section of equity (for example, under the beneficial conversion feature model). Namely, the liability and APIC components of a convertible debt instrument would be recombined as a single liability instrument and the APIC and preferred stock components of a convertible preferred stock instrument would be recombined as a single equity instrument. The inception-date adjusted carrying amount of the combined instrument should be determined by recalculating what it would have been if the conversion option had not previously been separately recognized in APIC. In determining the impact of adoption for convertible debt, and for redeemable preferred stock that is accreted up to its redemption amount, it is necessary to recalculate the effective interest rate and then recalculate the amortization of any discount (or premium) to arrive at the combined instrument's adjusted carrying amount upon adoption.

Before concluding that the accounting for a liability-classified freestanding instrument, such as a warrant, or embedded feature, such as a conversion option that required derivative treatment, should change as a consequence of the ASU eliminating certain requirements to qualify for the derivatives scope exception, it is important to keep in mind that a warrant may require liability treatment and a conversion option may require derivative treatment for various reasons. Hence the need to reperform the accounting analysis required under ASC 815-40, and additionally for warrants and other freestanding equity-linked instruments, the accounting analysis required under ASC 480.

If, as a result of the adoption of the ASU, an equity-linked instrument such as a warrant that was previously classified as a liability qualifies (through the application of the scope exception) to be classified as equity, its carrying amount is adjusted to what would have been its initial measurement. In determining the cumulative-effect adjustment and reestablishing the carrying amount of the reclassified instrument, it may be necessary to reallocate proceeds of a transaction involving multiple financial instruments to the various instruments. For example, warrants commonly are issued with other financial instruments, such as debt or stock. If, prior to adoption of ASU 2020-06, a warrant required liability classification, its initial carrying amount was likely its fair value. Upon its reclassification to equity, assuming it was issued with multiple instruments such that a re-allocation of proceeds is necessary, its initial carrying amount would be based on its proportionate fair value as elaborated on in Section 1.3 of this guide. Determining proportionate fair value could necessitate obtaining issuance-date valuations for any instruments issued with warrants if issuance-date fair values are otherwise not available. The reallocation of proceeds could impact the discount created on any debt or redeemable preferred stock instrument issued in the transaction, which (a) would impact the amount of interest expense or dividend that is recognized over the life of the debt or redeemable preferred stock (if that preferred stock is accreted to its redemption value) and (b) could impact the determination of whether an embedded put or call feature requires derivative recognition by impacting the conclusion reached on whether its economic characteristics and risks are clearly and closely related to the host contract under ASC 815-15-25-26 and ASC 815-15-25-42.

An entity that has not yet adopted the pending content that links to ASC 260-10-65-4 from ASU 2017-11(which pertains to the accounting for freestanding instruments with down round features) can early adopt the recognition and measurement amendments in ASU 2020-06 for convertible instruments that include a down round feature. This early adoption is permitted for fiscal years beginning after December 15, 2019 to coincide with the effective date of ASU 2017-11 for private companies. In permitting this limited early adoption of certain provisions of ASU 2020-06, an entity can avoid multiple transitions that otherwise could occur if an entity first adopts ASU 2017-11 and is no longer required to recognize a conversion option as a derivative. This is because upon the adoption of ASU 2017-11, an entity may need to recognize a cash conversion feature or a contingent beneficial conversion feature as a separate component of equity that would need to be reversed upon the adoption of the convertible instrument provisions of ASU 2020-06.

An entity may also irrevocably elect the fair value option in accordance with ASC 825-10 for any liability-classified convertible financial instrument within its scope upon the adoption of ASU 2020-06. (Convertible instruments that are issued at a substantial premium that is recognized in equity as a consequence of ASC 470-20 [as amended] are ineligible for the fair value option under ASC 825-10-15-5[f].) For any instrument for which the fair value option is elected under this transition provision, the difference between its carrying amount and the fair value should be recorded through a cumulative-effect adjustment to the opening retained earnings balance as of the beginning of the first reporting period of adoption.

Appendix D: Ramifications of ASU 2017-11

On July 13, 2017, the FASB issued ASU 2017-11. Part I applies to entities that issue financial instruments such as warrants, convertible debt or convertible preferred stock that contain down round features. Part II simply replaces the indefinite deferral for certain mandatorily redeemable noncontrolling interests and mandatorily redeemable financial instruments of nonpublic entities contained within ASC 480 with a scope exception and does not impact the accounting for these mandatorily redeemable instruments. Given that Part I can significantly impact the accounting for instruments within its scope, it is the focus of this appendix.

D.1 Overview

Down round features are a common reason why warrants and conversion options are required to be accounted for as liabilities and measured at fair value through earnings. Ongoing fair value measurement can be costly and create significant income statement volatility which are primary factors that led to the issuance of ASU 2017-11. A down round feature is defined as follows in the Master Glossary of the ASC:

> A feature in a financial instrument that reduces the strike price of an issued financial instrument if the issuer sells shares of its stock for an amount less than the currently stated strike price of the issued financial instrument or issues an equity-linked financial instrument with a strike price below the currently stated strike price of the issued financial instrument. A down round feature may reduce the strike price of a financial instrument to the current issuance price, or the reduction may be limited by a floor or on the basis of a formula that results in a price that is at a discount to the original exercise price but above the new issuance price of the shares, or may reduce the strike price to below the current issuance price.

A down round feature is most commonly outlined in an adjustments section of a convertible preferred stock certificate, convertible debt agreement, warrant agreement or other equity-linked instrument. ASC 815-40-55-33 illustrates a down round in the context of a warrant to buy 100 shares of the entity's common stock for $10 per share. The terms of the warrant specify that if the entity sells shares of its common stock for an amount less than $10 per share, the strike price of the warrants is reduced to equal the issuance price of those shares. Additionally, if the entity issues an equity-linked financial instrument with a strike price below $10 per share, the strike price of the warrants is reduced to equal the strike price of the newly issued equity-linked financial instrument. (In other words, if the entity were to issue a convertible instrument with a conversion price below $10, or other warrants with a strike or exercise price below $10, the strike price of the warrant to buy 100 shares would be adjusted down to that lower price.)

While in this example, the strike price is adjusted down to equal the issuance or exercise price of the subsequently issued shares, the definition of a down round extends to adjustments that are limited by a floor or based on a formula, as well as those that provide for a reduction to the strike price below the current issuance price. Standard anti-dilution provisions that provide for adjustments to the strike price for equity restructuring transactions such as stock dividends and splits, spinoffs, rights offerings or recapitalization through a large, recurring cash dividend are not considered to be down round features.

In practice, we have most commonly observed down round features in warrants, as well as convertible debt and preferred stock. Under the pre-existing guidance in ASC 815-40, a freestanding instrument, such as a warrant, that has a down round feature is required to be accounted for as a liability, typically at fair value with changes in fair value recognized in earnings. Additionally, a conversion option in both convertible debt and convertible preferred stock that is subject to potential adjustment due to a down round feature is required to be separately recognized at fair value as a derivative liability, with changes in fair value recognized in earnings if the conversion option by definition is a derivative and the other requirements for separation in ASC 815-15-25-1 are met.

As a result of amendments to ASC 815-40 made by ASU 2017-11, upon its adoption, freestanding equity-linked financial instruments, such as warrants, and conversion options in convertible debt or preferred stock, should no longer be accounted for as a derivative liability at fair value as a result of the existence of a down round feature. It is important to note that ongoing derivative treatment may be required for other

reasons; thus, a careful accounting analysis is necessary to determine the impact of adoption as is elaborated on in the "Important implementation considerations" section that follows.

D.2 Accounting upon triggering a down round feature

ASU 2017-11 amended ASC 260 to incorporate new guidance relevant to freestanding equity-classified financial instruments (e.g., warrants) with down round features. This guidance applies only to entities that are required to or voluntarily present EPS. Each time a down round feature is triggered in a freestanding equity-classified financial instrument (i.e., the strike price is reduced), the effect (value created) is accounted for by an entity that presents EPS as a dividend through a reduction to retaining earnings and an increase to the instrument's carrying amount (e.g., additional paid in capital for warrants). This amount also reduces income available to common shareholders in basic EPS. The carrying amount of the equity-classified instrument is not subject to further adjustment unless the down round feature is triggered again.

The amount to be recognized as a dividend is the difference between the following two amounts determined in accordance with ASC 820 immediately after the down round feature is triggered:

1. The fair value of the financial instrument (ignoring the down round feature) with the strike price that was in effect before the strike price reduction
2. The fair value of the financial instrument (ignoring the down round feature) with the reduced strike price resulting from the down round being triggered

An example of this accounting is provided at Section 5.2.2.2.2.1. It should be noted that while the down round feature is ignored when determining the fair value of the instrument for the purpose of this computation, all features of an instrument (including a down round feature) should be considered when it is necessary to determine the fair value of an instrument for other purposes (such as to establish its initial carrying amount). Additionally, this accounting does not apply to liability classified instruments, which generally require ongoing fair value measurement through earnings.

Prior to the issuance of ASU 2020-06, convertible instruments were not subject to the guidance added to ASC 260 as there was existing guidance in ASC 470-20 (refer to Section 3.4 and Section 4.4 for convertible debt and convertible preferred stock, respectively), as well as relevant EPS guidance in ASC 260, to address conversion features that are not required to be accounted for as a derivative. (As discussed in Section 4.5.1 of this guide, with the issuance of ASU 2020-06, ASC 260 also addresses the accounting for the effect of a down round feature that is triggered in convertible preferred stock). Therefore, prior to the adoption of ASU 2020-06, a beneficial conversion feature likely will need to be recognized in accordance with Section 3.4.2.2.1 when a down round feature is triggered in a convertible instrument, assuming separate recognition of the conversion option is not required under ASC 815 or the Cash Conversion subsections of ASC 470-20.

D.3 Effective date and transition

The effective date for public business entities is fiscal years, and interim periods within those fiscal years, beginning after December 15, 2018, and for all other entities, fiscal years beginning after December 15, 2019, and interim periods within fiscal years beginning after December 15, 2020. Early adoption is permitted, including adoption in an interim period, in which case any adjustments should be reflected as of the beginning of the fiscal year that includes that interim period.

ASU 2017-11 permits the amendments to be applied in one of two ways:

1. Retrospectively to outstanding financial instruments with a down round feature by means of a cumulative-effect adjustment to the statement of financial position as of the beginning of the first fiscal year and interim period(s) of adoption (i.e., modified retrospective application)

2. Retrospectively to outstanding financial instruments with a down round feature for each prior reporting period presented (i.e., retrospective application)

D.4 Important implementation considerations

To determine the impact of adoption to instruments that are outstanding at the date of adoption, an entity will need to reperform the accounting analysis for freestanding equity-linked instruments and embedded features that require derivative treatment due to a down round feature, as though ASU 2017-11 was in effect throughout the life of each instrument. The following sections of this guide will be useful in that regard:

- Section 5.2.2.1 and Section 5.2.2.2 to determine if a conversion option that previously required derivative treatment qualifies for the scope exclusion provided by ASC 815-10-15-74(a) when disregarding the down round feature, and if so, prior to the adoption of ASU 2020-06, Section 3.4 for convertible debt and Section 4.4 for convertible preferred stock to determine if a portion of the instrument should be recognized as additional paid-in capital in accordance with ASC 470-20
- Guidance beginning at Section 5.2 to determine if a freestanding instrument such as a warrant can be reclassified to equity, given that the down round feature will be disregarded when determining the balance sheet classification of the instrument

Careful consideration needs to be given to all the terms of an instrument, as well as other facts and circumstances, before concluding that as a consequence of ASU 2017-11, an instrument or conversion option no longer requires derivative treatment. It is our understanding through discussions with the FASB staff that the definition of a down round is intended to be strictly applied. We have observed numerous agreements in practice that provide for adjustments to the strike price of an instrument that are similar to a down round but provide for protection that extends beyond a down round feature as defined. An example includes an adjustment that is triggered by contractual changes to the strike price of another instrument. The definition of a down round and the illustration at Example 9 in ASC 815-40-55 provide for reductions to the strike price when the issuer sells or issues shares at a lower price and do not extend to changes to the strike price of another instrument.

D.4.1 Ramifications associated with reclassifying a freestanding instrument from liability to equity

As is more fully elaborated on in the “Basis for Conclusions” of ASU 2017-11 (beginning at BC50), if, upon adoption, a freestanding instrument is reclassified from a liability to equity, the difference in retained earnings that would have been reported if ASU 2017-11 was in effect at the issuance and throughout the term of the financial instrument is recognized as a cumulative-effect adjustment of the opening balance of retained earnings. In determining the cumulative-effect adjustment and re-establishing the carrying amount of the reclassified instrument, it may be necessary to re-allocate the proceeds of a transaction involving multiple financial instruments to the various instruments. For example, warrants are commonly issued with other financial instruments such as debt or stock. If prior to the adoption of ASU 2017-11, a warrant required liability classification, its initial carrying amount was likely its fair value. Upon its reclassification to equity, its initial carrying amount would be based on its relative fair value as is elaborated on in Section 1.3 of this guide. This could necessitate obtaining issuance date valuations for any instruments issued with warrants if issuance date fair values are otherwise not available.

Various ancillary ramifications could result if the amount of proceeds is re-allocated to other instruments that may have been issued in a bundled transaction, given the need to account for each instrument as though ASU 2017-11 was in effect at its issuance and throughout its term.[10] For example,

[10] This understanding was confirmed through discussions with the FASB staff.

- If warrants were issued with convertible instruments, the proceeds allocated to the warrants would impact the analysis of whether and to what extent a beneficial conversion feature is present in the convertible instrument (if ASU 2020-06 is adopted after ASU 2017-11).
- If warrants were issued with debt or debt-like host contracts (e.g. certain redeemable preferred stock), the amount of proceeds allocated to the warrants would generally create a discount on the debt or redeemable stock and therefore typically impact the determination of whether a put or call feature embedded in the debt or redeemable stock has economic characteristics and risks that are clearly and closely related to the host contract in light of the analysis that is required under ASC 815-15-25-26 and ASC 815-15-25-42.

To the extent proceeds are allocated to warrants, a discount would be created (or premium reduced) on a debt or redeemable preferred stock instrument, which would impact the amount of interest expense or dividend that is recognized over the life of the debt or redeemable preferred stock (if that preferred stock is accreted to its redemption value).

In determining the cumulative-effect adjustment associated with reclassifying a freestanding instrument to equity, entities that present EPS also should consider adjustments to the instrument's carrying amount that may be necessary if a down round feature was triggered prior to the adoption of ASU 2017-11, given the amendments to ASC 260-10.

D.4.2 Ramifications when a conversion option no longer requires derivative treatment

If, upon adoption, a conversion option in a convertible instrument no longer requires derivative treatment, it is recombined with the host instrument at the date of adoption. The difference in retained earnings that would have been reported if ASU 2017-11 was in effect at issuance of the convertible instrument is recognized as a cumulative-effect adjustment of the opening balance of retained earnings and as an adjustment of the carrying amount of the recombined instrument. The recombined instrument should be classified as a liability or equity instrument in its entirety as appropriate. However, if prior to the adoption of ASU 2020-06, the convertible instrument has a cash conversion feature or a beneficial conversion feature (as elaborated on in ASC 470-20, as well as Section 3.4 and Section 4.4 of this guide for convertible debt and convertible preferred stock, respectively) that was triggered before the effective date of ASU 2017-11, upon adoption, a portion of the convertible instrument would be reported in additional paid in capital as if ASC 470-20 had been applied upon issuance or upon trigger, as appropriate, with any resulting difference in retained earnings recognized as a cumulative-effect adjustment of the opening balance of retained earnings.

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